No. 87-1168-CFX
Status: GRANTED

Title: Commissioner of Internal Revenue, Petitioner
v.
Donald E. Clark, et ux.

Docketed:
January 11, 1988

Court: United States Court of Appeals
for the Fourth Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Slocombe,Walter B.

NOTE: Time to file ext. by CJ to & incl. 1/11/88 cited

Entry	Date	Note	Proceedings and Orders
1	Nov 23 1987		Application for extension of time to file petition and order granting same until January 2, 1988 (Chief Justice, November 24, 1987).
2	Dec 16 1987		Application for further extension of time to file petition and order granting same until January 11, 1988 (Chief Justice, December 17, 1987).
3	Jan 11 1988	G	Petition for writ of certiorari filed.
4	Feb 12 1988		Brief of respondents Donald Clark, et ux. in opposition filed.
5	Feb 17 1988		DISTRIBUTED. March 4, 1988
6	Mar 1 1988	X	Reply brief of petitioner CIR filed.
7	Mar 7 1988		Petition GRANTED.
			**********
9	Apr 7 1988		Joint appendix filed.
11	Apr 19 1988		Order extending time to file brief of petitioner on the merits until May 5, 1988.
12	May 5 1988		Brief of petitioner CIR filed.
14	May 31 1988		Order extending time to file brief of respondent on the merits until June 20, 1988.
15	Jun 13 1988		Record filed.
		*	Certified copy of original record and proceedings, 4 volumes, received.
16	Jun 20 1988		Brief of respondents Donald Clark, et ux. filed.
17	Jun 23 1988		CIRCULATED.
18	Jul 20 1988	X	Reply brief of petitioner CIR filed.
19	Aug 29 1988		Set for argument. Monday, November 7, 1988. (1st case) (1 hr).
20	Nov 7 1988		ARGUED.

87-1168

No.

Supreme Court, U.S.
FILED
JAN 11 1988
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

DONALD B. AYER
Acting Solicitor General

WILLIAM S. ROSE, JR.
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

ERNEST J. BROWN
Attorney

Department of Justice
Washington, D.C. 20530
(202) 633-2217

75 pp

QUESTION PRESENTED

In this case, a relatively small corporation was merged into a subsidiary of a large publicly-owned corporation, and the sole shareholder of the acquired corporation received in exchange for his shares both cash and shares of the stock of the publicly-owned corporation. The question presented is whether that payment of cash had the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2) of the Internal Revenue Code.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statute involved	2
Statement	2
Reasons for granting the petition	6
Conclusion	23
Appendix A	1a
Appendix B	15a
Appendix C	40a
Appendix D	41a

TABLE OF AUTHORITIES

Cases:

Baker v. *United States*, 460 F.2d 827 (8th Cir. 1972)	22
Campbell v. *Commissioner*, 144 F.2d 177 (3d Cir. 1944)	8, 15, 16
Commissioner v. *Estate of Bedford*, 325 U.S. 283 (1945)	16, 17
Commissioner v. *Forhan Realty Corp.*, 75 F.2d 268 (2d Cir. 1935)	15
Commissioner v. *Gordon*, 391 U.S. 83 (1968)	12
Commissioner v. *Munter*, 331 U.S. 210 (1947)	11
Commissioner v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974)	20
Commissioner v. *Owens*, 69 F.2d 597 (5th Cir. 1934)	14, 16
Commissioner v. *Phipps*, 336 U.S. 410 (1949)	11
DeGroff v. *Commissioner*, 444 F.2d 1385 (10th Cir. 1971)	15
Don E. Williams Co. v. *Commissioner*, 429 U.S. 569 (1977)	20, 21
Estate of Uris v. *Commissioner*, 605 F.2d 1258 (2d Cir. 1979)	22
Foster v. *United States*, 303 U.S. 118 (1938)	11, 22
General Housewares Corp. v. *United States*, 615 F.2d 1056 (5th Cir. 1980)	16
Hawkinson v. *Commissioner*, 235 F.2d 747 (2d Cir. 1956)	8, 15,17

BEST AVAILABLE COPY

Cases-Continued: Page

Idaho Power Co. v. *United States*, 161 F. Supp. 807 (Ct. Cl.), cert. denied, 358 U.S. 832 (1958) 16
King Enterprises, Inc. v. *United States*, 418 F.2d 511 (Ct. Cl. 1969) 8, 15, 17
Lewis v. *Commissioner*, 176 F.2d 646 (1st Cir. 1949) .. 13, 15-16
Liddon v. *Commissioner*, 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956) 15
Love v. *Commissioner*, 113 F.2d 236 (3d Cir. 1940) 16
Pridemark, Inc. v. *Commissioner*, 345 F.2d 35 (4th Cir. 1965) 16
Rose v. *Little Investment Co.*, 86 F.2d 50 (5th Cir. 1936) .. 15
Ross v. *United States*, 173 F. Supp. 793 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959) 15, 16, 17
Sheldon v. *Commissioner*, 6 T.C. 510 (1946) 15
Shimberg v. *United States*, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) 4, 6, 7, 8, 16, 17, 18, 19
United States v. *Davis*, 397 U.S. 301 (1970) 19
Woodward v. *Commissioner*:
23 B.T.A. 1259 (1931) 15, 16
30 B.T.A. 1216 (1934) 15
Wright v. *United States*, 482 F.2d 600 (8th Cir. 1973) .. 4, 17, 18

Statutes and regulation:

Internal Revenue Code (26 U.S.C.):
§ 243 8
§ 302 ..... 2, 5, 19, 20
§ 302(b)(2) 5
§ 302(d) 19
§ 316 ..... 2, 12
§ 316(a) 7
§ 317 ..... 2, 12
§ 354 ..... 2, 13
§ 356 2
§ 356(a) 13
§ 356(a)(2) 4, 6, 10, 11, 14, 17, 19, 20, 22
§ 358 13
§ 368 13
§ 368(a)(1)(A) 3, 14
§ 368(a)(1)(C) 14
§ 368(a)(1)(D) 15

Statutes and regulation-Continued Page

§ 368(a)(2)(D) 3
§ 1211(b) 9
Revenue Act of 1921, ch. 136, 42 Stat. 227 12
§ 202(c)(2), 42 Stat. 230 13
§ 202(d)(1), 42 Stat. 230 13
Revenue Act of 1924, ch. 234, § 203(d), 43 Stat. 257 13
Treas. Reg. § 1.368-1(b) 13

Miscellaneous:

Darrell, *The Scope of* Commissioner *v.* Bedford Estate, 24 Taxes 266 (1946) 17
H.R. Rep. 179, 68th Cong., 1st Sess. (1924) 13
H.R. Rep. 99-841, 99th Cong., 2d Sess. Pt. II (1986) 9
Rev. Rul. 74-515, 1974-2 C.B. 118 17
Rev. Rul. 74-516, 1974-2 C.B. 121 ..... 17, 20
S. Rep. 275, 67th Cong., 1st Sess. (1921) 13
S. Rep. 398, 68th Cong., 1st Sess. (1924) 13
Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965) 17

In the Supreme Court of the United States

OCTOBER TERM, 1987

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra,* 1a-14a) is reported at 828 F.2d 221. The opinion of the Tax Court (App., *infra,* 15a-39a) is reported at 86 T.C. 138.

JURISDICTION

The judgment of the court of appeals (App., *infra,* 40a) was entered on September 4, 1987. On November 24, 1987, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including January 2, 1988. On December 17, 1987, the Chief Justice further extended the time for filing a petition for a writ of certiorari to and including January 11, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

The relevant portions of Sections 302, 316, 317, 354, and 356 of the Internal Revenue Code (26 U.S.C.) are set forth in a statutory appendix (App., *infra,* 41a-45a).

STATEMENT

For some time prior to April 1979, respondent Donald E. Clark[1] was the president of Basin Surveys, Inc., a West Virginia corporation that furnished radiation, nuclear, and electronic open-hole logging services to the petroleum industry, and he owned all of its outstanding 58 shares of stock. N.L. Industries, Inc. (NL) was then a publicly-held New Jersey corporation engaged in manufacturing and supplying petroleum equipment and services, chemicals, and metals. NL had outstanding approximately 32,533,000 shares of a single class of common stock and 500,000 shares of preferred stock. That stock was publicly traded on the New York and Pacific Stock Exchanges. N.L. Acquisition Corp. (NLAC) was a wholly owned subsidiary of NL. App., *infra,* 16a.

In 1978, NL had initiated discussions with respondent concerning the possible acquisition of Basin. After several months of negotiations, NL offered respondent alternative terms for the acquisition of Basin: (1) 425,000 shares of NL common stock without cash; or (2) 300,000 shares of common stock and $3,250,000 in cash. Respondent decided in favor of the latter alternative. App., *infra,* 16a.[2]

---

[1] Respondent Peggy S. Clark is a party herein only because she filed a joint federal income tax return for the calendar year 1979 with her husband, respondent Donald E. Clark. References to "respondent" in the singular will be to Donald E. Clark.

[2] In the Tax Court, respondent's attorney testified (and it was agreed that, if called, respondent would testify to the same effect) that, after receiving NL's alternative offers, respondent had requested

On April 3, 1979, an agreement and plan of merger was executed by Basin, NLAC, NL, and respondent. The plan provided that, on April 18, 1979, Basin would merge with and into NLAC, which would change its name to Basin Surveys, Inc., and that respondent would receive, with respect to each of the 58 shares of Basin that he owned, 5,172.4137 shares of NL common stock and $56,034.482 in cash. The merger took place as planned. Respondent received 300,000 shares of NL common stock and $3,250,000 in cash, and ne entered into an employment agreement with Basin Surveys, Inc., for three years and an agreement not to compete for five years. The parties stipulated that the merger of Basin into NLAC was effected pursuant to, and qualified as a reorganization under, Section 368(a)(1)(A) and (a)(2)(D) of the Internal Revenue Code.[3] App., *infra,* 16a-17a.

2. Section 356(a)(1) of the Code provides that, if cash or other property is received in the course of what would otherwise be a tax-free, stock-for-stock reorganization, the recipient must recognize his gain on the transaction up to the value of that other property received. Accordingly, in their joint federal income tax return for 1979, respondents reported the cash received in the merger, com-

---

the NL representatives to leave the room, so that the two of them could discuss the matter. In that discussion, the factors that led to a tentative choice of the latter alternative were that respondent's "whole livelihood was tied up in his company," and that an all-stock deal would involve the risk of serious loss if something happened to NL. Moreover, the stock of NL that was to be received would not be registered stock, but would be restricted letter stock, which would mean, under SEC rules, that respondent would have to hold the stock for a couple of years if he wanted to sell it and receive full value. And, in view of respondent's complete involvement with his company, that, in turn, would have meant that he could not pay his outstanding bills. C.A. App. 48-53.

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

monly known as "boot," as taxable gain.[4] They characterized this amount as long-term capital gain. Section 356(a)(2) of the Code, however, requires that, if the exchange "has the effect of a distribution of a dividend," the recipient must treat the property received as a dividend to the extent of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. Under this Section, the Commissioner determined that $2,319,611 of the reported gain (i.e., the amount of the accumulated earnings and profits of Basin at the time of the merger) should be treated as a dividend and therefore taxable as ordinary income rather than as capital gain. This determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979.

3. Respondents petitioned for review in the Tax Court, which ruled in their favor in a reviewed decision (App., *infra,* 15a-39a). The court viewed the question whether respondents' receipt of cash in the merger had the effect of the distribution of a dividend as turning on a choice between two "judicially articulated tests" set forth in *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973), and *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) (App., *infra,* 18a). According to the Tax Court, the *Shimberg* test would treat the cash distribution as if it constituted a distribution by the acquired corporation prior to the merger, and the *Wright* test would treat the cash payment as if it constituted "a distribution by the *acquiring* corporation (NL) in a hypothetical redemption of the shares of NL stock that would have been received if petitioner had accepted stock in lieu of the cash consideration" (App., *infra,* 18a (emphasis in original)).

[4] The figure reported by respondents on their return was $3,195,294. In their later computation for entry of decision by the Tax Court, respondents acknowledged that the amount of gain recognized and reported should have been $3,250,000.

The Tax Court then concluded that it should follow *Wright* and treat the cash payment as part of a post-merger hypothetical redemption of the 125,000 shares of NL stock that respondent declined to accept as payment. The court stated that this approach was necessary if the cash payment is to "be viewed and tested within the context of the entire reorganization" (App., *infra,* 33a). Because such a hypothetical redemption would have reduced respondent's holdings in NL from 425,000 to 300,000, it would not have been essentially equivalent to a dividend under the redemption provisions of the Code (see Section 302(b)(2)).[5] Under the Tax Court's approach, this conclusion meant that the cash received by respondents should not be viewed as a dividend in the reorganization context either, and therefore respondents were entitled to capital gain treatment upon the reported gain. App., *infra,* 34a-35a.

4. The court of appeals affirmed (App., *infra,* 1a-14a). Like the Tax Court, the court of appeals approached the case as requiring it to choose between *Wright* and *Shimberg* (see App., *infra,* 8a). The court first concluded that the dividend determination was to be made by importing into the reorganization context the principles applicable to redemptions under Section 302 of the Code (App., *infra,* 3a-6a). The court then concluded that the tests of Section 302 should be applied as if there had been a hypothetical redemption after the reorganization was

[5] Under the "safe harbor" provisions of Section 302(b)(2), cash received upon a "subtantially disproportionate redemption" will not be treated as a dividend. The statute defines such a redemption as one in which the shareholder's percentage interest in voting stock in the corporation following the redemption is less than 80% of what it was before the redemption and he retains less than 50% of the voting power in the corporation following the redemption.

completed, and hence that whether the cash payment was a dividend turned on the extent of the reduction in respondent's interest in NL occasioned by the hypothetical redemption (App., *infra,* 7a-11a). The court criticized the *Shimberg* approach of treating the cash payment as being made by the acquired corporation (App., *infra,* 10a-14a), stating, inter alia, that it failed adequately to consider "the corporate control he retained after the reorganization was completed" (*id.* at 10a-11a).

REASONS FOR GRANTING THE PETITION

The court of appeals' decision in this case has created a clear conflict in the circuits with respect to the treatment under Section 356(a)(2) of the Code of cash or other property received in a reorganization. This conflict, if allowed to persist, will create severe administrative problems for the Internal Revenue Service. Depending on their situation, different types of shareholders have different preferences for the treatment of the cash that they receive in a reorganization. Accordingly, regardless of which of the court of appeals decisions that it follows, the IRS can expect some taxpayers to challenge its treatment. Unless the conflict is resolved, therefore, the issue presented here is destined to remain a continual source of dispute and litigation. Moreover, the decision below unjustifiably departs from a long line of contrary authority on a recurring issue on which there are frequently large sums of money at stake. For these reasons, it is appropriate for this Court to grant certiorari to resolve the conflict.

1. There can be no doubt that the decision below directly conflicts with *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979). As the Tax Court noted (App., *infra,* 27a), *Shimberg* involved "a factual set of circumstances similar to the instant case," and there is no principled basis for reaching a different result in the two cases. In *Shimberg* a smaller corporation was merged into a larger one, and the shareholders of the acquired corporation received shares in the acquiring corporation, plus $625,000 in cash, to be allocated among the shareholders on a pro rata basis. Shimberg, who owned a majority of the shares of stock in the acquired corporation, reported his share of the cash received as long-term captial gain, but the Commissioner determined that it should be taxed as a dividend.

The court of appeals in *Shimberg* rejected the taxpayer's contention that redemption principles—namely, whether receipt of the cash in a hypothetical redemption of his shares in the acquiring corporation would have resulted in a meaningful reduction of his interest in that corporation—should be applied to determine whether the cash was equivalent to a dividend. The court stated (577 F.2d at 287 (footnote omitted)): "We agree with the government that 'the undifferentiating invocation of stock redemption principles in a reorganization case' such as this one is erroneous, and we decline to apply on a wholesale basis the 'meaningful reduction' test in cases arising under §356(a)(2)." Rather, the court explained, a "dividend" is generally defined by Section 316(a) of the Code as "any distribution of property made by a corporation to its shareholders * * * out of its earnings and profits." Accordingly, "[i]f a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a 'continuance of the proprietary interests in the continuing enterprise under modified corporate form,' it follows that the pro rata distribution of 'boot' to shareholders of one of the participating corporations must certainly have the 'effect of the distribution of a dividend' within the meaning of § 356(a)(2)." The court concluded that "§ 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred." 577 F.2d at 288.

It is evident that the holding of *Shimberg* is precisely the contention that was rejected here, and, as the court of appeals apparently recognized (see App., *infra,* 7a-8a, 13a-14a), the two decisions are irreconcilable. Moreover, the decision below also conflicts with the decisions of other courts of appeals relied upon in *Shimberg* (see 577 F.2d at 288) that recognized the appropriateness of dividend treatment in situations parallel to that presented here. See, *e.g., King Enterprises, Inc.* v. *United States,* 418 F.2d 511, 521 (Ct. Cl. 1969); *Hawkinson* v. *Commissioner,* 235 F.2d 747, 751 (2d Cir. 1956); *Campbell* v. *Commissioner,* 144 F.2d 177, 181-182 (3d Cir. 1944); see pages 14-16, *infra.* Thus, unless the Court grants certiorari here, different taxpayers will receive disparate tax treatment on the same transaction depending upon the circuit in which their case arises.

2. The conflict in the circuits created by the decision below will create substantial administrative problems for the IRS unless it is resolved. The issue presented here is one on which the respective interests of individual shareholders and corporate shareholders have long been sharply divergent. At least since 1936, because of the tax advantages of capital gains as opposed to ordinary income, it has been in the interest of individual shareholders, like respondents, not to have dividend treatment for gain recognized on boot received on a reorganization. On the other hand, corporate shareholders participating in the same or similar transactions have preferred to have such gain treated as a dividend, because of the deduction for intercorporate dividends allowed by Section 243 of the Code (generally 85% under present law). Thus, even if the Commissioner were to abandon his longstanding position on this issue and were to adopt the approach taken by the court below, that would not put an end to the controversy over the treatment of boot. It can reasonably be anticipated that corporate shareholders,

relying on *Shimberg* and the cases cited therein, would challenge the Commissioner's new position and argue for dividend treatment. Thus, the only way to end the controversy over the issue presented in this case is by means of a definitive resolution of the conflict in the circuits.

In the wake of the Tax Reform Act of 1986, which eliminated the differential tax rates between capital gains and ordinary income, one can expect a significant diminution in the number of individual shareholders whose interests will be adversely affected by dividend treatment of boot.[6] There will, however, remain shareholders in this category; individuals who have, or can carry forward, capital losses on other transactions will want their gain in a reorganization to be classified as capital gain, rather than as a dividend, so that they will be able to take a full deduction for the capital losses (see I.R.C. § 1211(b)). The 1986 Act will not affect the interests of corporate shareholders. Because of the intercorporate dividend deduction, they retain the same interest in contesting any effort by the Commissioner to deny dividend treatment to gain recognized on boot received in a reorganization.

Moreover, quite apart from the question of the characterization of the gain recognized by the shareholders of the acquired corporation, the conflict in the circuits injects considerable uncertainty into the treatment of other important tax accounts. The court below has held that "the boot should be characterized as a post-reorganization stock redemption by N.L." (App., *infra,* 7a). If that characterization is followed, it would necessitate several

---

[6] Congress, however, apparently viewed the elimination of the differential tax rates for capital gain and ordinary income, which had been part of the revenue laws since 1921, as something of an experiment. Congress stated that it was retaining the existing statutory structure for capital gains in the Code in order "to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase." H.R. Rep. 99-841, 99th Cong., 2d Sess. Pt. II, at 106 (1986).

adjustments because, as discussed in detail *infra* (at 21-22), the receipt of additional stock that is subsequently redeemed has different collateral consequences from the receipt of boot. The receipt of additional shares in the transaction, which has the effect of spreading thinner the total basis transferred from the surrendered shares, means that the basis of each individual share retained after the merger would be smaller than if the boot were characterized as a dividend. And because the gain recognized on a redemption is reduced by the basis of the redeemed shares, the gain recognized in the merger will be different depending on whether the boot is characterized as a post-reorganization redemption. See pages 21-22, *infra*.

The disparities created by the conflict are even more pronounced in connection with the earnings and profits accounts. Under Section 356(a)(2) dividend treatment, the accumulated earnings and profits of the acquired corporation would be depleted by the amount of the dividend, and those earnings and profits would not be available for future dividends issued by the reorganized entity. On the other hand, if the boot is treated as coming from a hypothetical post-reorganization redemption, the earnings and profits of the acquired corporation ought to survive in the reorganized entity. Instead, the redemption presumably would draw upon the earnings and profits of the corporation whose stock was being redeemed; on the facts of this case, for example, that would lead to a substantially different post-reorganization earnings and profits structure (see pages 21-22, *infra*).[7] Thus, the difference between treating the boot as a dividend issued by the acquired corporation, on the one hand, and as a hypothetical post-reorganization redemption, on the other, may be reflected in continuing accounts, like basis and earnings and profits, that will have tax effects—and may lead to disputes—many years after the reorganization is complete.[8] Accordingly, it is of considerable importance for the Commissioner to know at the outset how to treat these transactions and to be able to apply a uniform rule nationwide. In sum, the 1986 Act does not eliminate the need to resolve the conflict in the circuits in order to permit the Commissioner to avoid an administrative quandary.

[7] Moreover, if the transaction is truly to be treated as a redemption, there would be additional differences because a redemption may draw upon capital and upon both accumulated earnings and profits and also those for the taxable year, whereas a Section 356(a)(2) dividend draws only upon accumulated earnings and profits. See page 22, *infra*.

Moreover, while it is possible that litigation in this area will increase now that the Fourth Circuit has flatly rejected a published IRS position that has been accepted by several courts, it must be emphasized that the administrative difficulties caused by this conflict would not be restricted to the litigation arena. The area of corporate reorganizations is one that involves considerable planning and often includes a request for a private letter ruling from the IRS. The IRS reports that it has issued 190 letter rulings since 1982 on reorganizations involving boot; 110 of these contained explicit rulings on treatment of boot under Section 356(a)(2). Each ruling for a particular reorganization will be applicable to an undisclosed, often large, number of shareholders. And a single reorganization may involve both corporate and individual shareholders, whose interests will likely be at odds, and shareholders who reside in different circuits, where the precedent governing the treatment of boot is irreconcilable. It is essential for the IRS to have a uniform rule to apply in issuing these rulings.

[8] See, *e.g.*, *Commissioner* v. *Phipps*, 336 U.S. 410 (1949); *Commissioner* v. *Munter*, 331 U.S. 210 (1947); *Foster* v. *United States*, 303 U.S. 118 (1938).

BEST AVAILABLE COPY

3. The court of appeals erred in refusing to treat the boot received by respondents as a dividend. Section 316 of the Code provides that "the term 'dividend' means any distribution of property made by a corporation to its shareholders (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year * * *." It further provides that "[e]xcept as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof * * *." Section 317 in turn defines "property" for these purposes as "money, securities, and any other property." The Court summarized the effect of these provisions as follows (*Commissioner* v. *Gordon,* 391 U.S. 83, 88-89 (1968) (footnote omitted)):

> Under §§ 301 and 316 of the Code, and subject to the specific exceptions and qualifications provided in the Code, any distribution of property by a corporation to its shareholders out of accumulated earnings and profits is a dividend taxable to the shareholders as ordinary income. Every distribution of corporate property, again except as otherwise specifically provided, "is made out of earnings and profits to the extent thereof."

The reorganization provisions of the Code have their origin in the Revenue Act of 1921, ch. 136, 42 Stat. 227. In order to "permit business to go forward with the readjustments required by existing conditions without the immediate imposition of taxes" (S. Rep. 275, 67th Cong., 1st Sess. 11 (1921)), Section 202(c)(2) of that Act (42 Stat. 230) provided that no gain or loss should be recognized upon an exchange of stock or securities in one corporation that is a party to the reorganization for stock or securities in another corporation that is a party to the reorganization. Section 202(d)(1) (42 Stat. 230) instead provides that the stock or securities received on the exchange should take the same basis in the hands of the taxpayer as the surrendered stock or securities. This statutory structure (now codified in I.R.C. §§ 354, 358 and 368) embodies the principle that such a stock-for-stock reorganization is "a continuance of the proprietary interests in the continuing enterprise under modified corporate form" (*Lewis* v. *Commissioner,* 176 F.2d 646, 648 (1st Cir. 1949)). See also Treas. Reg. § 1.368-1(b).

In 1924, Congress refined the reorganization provisions that it had enacted three years earlier by addressing the treatment of a payment of cash, in addition to the stock or securities received tax-free, to the shareholders of one of the reorganizing corporations. It enacted the predecessor to Section 356(a) of the Code, Section 203(d) of the Revenue Act of 1924, ch. 234, 43 Stat. 257, which provided that (1) if, in addition to eligible stock or securities, money or other property was received on a reorganization exchange, gain should be recognized to the extent of that money or other property, but (2) if such a distribution "has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee" the amount of the gain that does not exceed his share of undistributed earnings and profits. Congress indicated that this provision was necessary to account accurately for distributions in the context of a reorganization that had the same effect "as if the corporation had declared out [the cash] as a dividend" directly without the reorganization. See H.R. Rep. 179, 68th Cong., 1st Sess. 15-16 (1924); S. Rep. 398, 68th Cong., 1st Sess. 15-16 (1924).

The logical import of all of these provisions is that boot in a reorganization that is distributed pro rata to the shareholders of one of the corporations should be treated as a dividend. A pro rata distribution of cash from a corporation to its shareholders is the classical form of dividend. And the reorganization provisions are designed to reflect the fact that the new corporation is a continuation of the same enterprise of the acquired corporation. Accordingly,

the pro rata "distribution of property" made in the course of the reorganization to the shareholders of one of the corporations almost falls within the specific terms of the definition of "dividend" in Section 316 and should be viewed as "essentially equivalent to a dividend" within the meaning of Section 356(a)(2).

In this vein, a long line of court of appeals' decisions in the wake of the 1924 Act recognized that, where two corporations not previously under common control are unified either by statutory merger or consolidation (I.R.C. § 368(a)(1)(A)) or by the transfer of substantially all of the assets of one to the other in exchange for voting stock of the latter (I.R.C. § 368(a)(1)(C)), and the shareholders of one or both corporations receive a pro rata payment of cash, that payment has the effect of a dividend and is to be taxed as such. The first case in this line is *Commissioner* v. *Owens,* 69 F.2d 597 (5th Cir. 1934), where two banks merged and the shareholders of the smaller bank received pro rata both stock in the new bank and cash. The court held that "so much of [the cash] as might before consolidating have been declared by their corporation as an ordinary dividend out of its profits is by [the predecessor of Section 356(a)(2)] to be so taxed" (69 F.2d at 598). The court specifically noted (*ibid.*): "It is true that the money was not distributed by the [acquired bank] and thus was not literally a dividend of that bank. But the statute speaks of a distribution which 'has the effect of the distribution of a dividend.' This pro rata payment to all stockholders of the [acquired bank] * * * certainly has that effect."

Subsequent to *Owens,* several other courts of appeals reached the same conclusion regarding boot received on a pro rata basis. See *King Enterprises, Inc.* v. *United States,* 418 F.2d at 521 ("The distribution on a pro rata basis, entailing no substantially disproportionate change in the continuing equity interests of the Tenco stockholders, constitutes a classic example of a transaction having the effect

of the distribution of a dividend."); *Hawkinson* v. *Commissioner,* 235 F.2d at 751 ("the distribution had all the earmarks of a taxable dividend, i.e., a pro rata distribution out of corporate earnings and profits"); *Campbell* v. *Commissioner,* 144 F.2d at 182 ("We [previously] held that when cash was distributed in a reorganization to the stock holders of the predecessor company that part of the amount thus distributed which equalled the accumulated earnings of the predecessor corporation had the effect of a taxable dividend and was accordingly taxable as such."); see also *Ross* v. *United States,* 173 F. Supp. 793, 798 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); *Rose* v. *Little Investment Co.,* 86 F.2d 50 (5th Cir. 1936); *Commissioner* v. *Forhan Realty Corp.,* 75 F.2d 268 (2d Cir. 1935); *Sheldon* v. *Commissioner,* 6 T.C. 510 (1946); *Woodward* v. *Commissioner,* 30 B.T.A. 1216, 1229-1230 (1934); *Woodward* v. *Commissioner,* 23 B.T.A. 1259 (1931).[9] On the other hand, where the cash payment was not pro rata to the shareholders of one of the corporations, but rather was made only to holders of preferred stock who did not own any common stock in order to call and retire that preferred stock, the payment was held not to have the effect of a

---

[9] All of these cases, like the present one, involve "A" or "C" reorganizations of corporations not under common control. There are many more cases requiring dividend treatment for boot received in a "D" reorganization ("a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders * * * is in control of the corporation to which the assets are transferred," I.R.C. § 368 (a)(1)(D)). See, *e.g., DeGroff* v. *Commissioner,* 444 F.2d 1385 (10th Cir. 1971); *Liddon* v. *Commissioner,* 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956); *Lewis* v. *Commissioner,* 176 F.2d 646 (1st Cir. 1949); *Love* v. *Commissioner,* 113 F.2d 236 (3d Cir. 1940); cf. *Pridemark, Inc.* v. *Commissioner,* 345 F.2d 35 (4th Cir. 1965).

dividend. *Idaho Power Co.* v. *United States,* 161 F. Supp. 807 (Ct. Cl.), cert. denied, 358 U.S. 832 (1958). This line of authority was capped by *Shimberg* v. *United States, supra,* which rejected the precise contention accepted by the court below (see pages 6-8, *supra*). See also *General Housewares Corp.* v. *United States,* 615 F.2d 1056, 1066 (5th Cir. 1980).[10]

Indeed, the existence of this established line of authority was noted approvingly by this Court in *Commissioner* v. *Estate of Bedford,* 325 U.S. 283 (1945). That case dealt with a factual situation somewhat different from the one here. The estate in *Bedford* was a shareholder of a corporation that engaged in a recapitalization or "E" reorganization. In exchange for 3,000 shares of preferred stock, the estate received 3,500 shares of a lesser preferred, 1,500 shares of common stock, and $45,240 in cash. The Court held that the cash came out of the corporation's accumulated earnings and hence had the effect of a dividend and was taxable at ordinary, rather than capital, gain rates. The court referred with approval to several of the cases cited above requiring dividend treatment in the case of reorganizations involving two corporations, and it stated (*id.* at 291): "We cannot distinguish the two situations and find no implication in the statute restricting [the predecessor of Section 356(a)(2)] to taxation as a dividend

[10] These cases uniformly recognize that dividend treatment does not turn upon which corporation physically pays out the cash to the shareholders. Whether the immediate source of the cash is the acquiring corporation, the acquired corporation, or the new corporation, a pro rata distribution to the shareholders of one corporation is a dividend to the extent of the accumulated earnings and profits of that latter corporation. See *Shimberg* v. *United States,* 577 F.2d at 289; *Ross* v. *United States,* 173 F. Supp. at 798; *Campbell* v. *Commissioner,* 144 F.2d at 182; *Commissioner* v. *Owens,* 69 F.2d at 598; *Woodward* v. *Commissioner,* 23 B.T.A. at 1362.

only in the case of an exchange of stock and assets of two corporations." [11]

Against this uniform body of decisional law, the court below erroneously relied upon *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973), which arose in a very different factual context. Wright was the principal shareholder in three different corporations engaged in construction and equipment leasing. Wright owned 71.5% of the stock of the construction company, and his field superintendent owned 27.9%. They wanted to merge the other two companies and create a new company (Omni) that would have a stock ownership ratio similar to that of the construction company. A simple stock-for-stock reorganization, however, would have given Wright a greater share of Omni than he desired. Therefore, the merger plan provided that, in addition to the exchange of

[11] In the course of rejecting an alternative argument made by the estate, the Court made the statement that "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' " (325 U.S. at 292). This statement was read by some as establishing an "automatic dividend" rule that would accord dividend treatment to any cash received on a reorganization, whether pro rata or not. This "automatic dividend" rule was heavily criticized by the commentators (see, *e.g.*, Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule,* 20 Tax L. Rev. 573 (1965); Darrell, *The Scope of* Commissioner *v.* Bedford Estate, 24 Taxes 266, 268-276 (1946)). The post-*Bedford* cases in this area, however, have rejected this broad reading and have concluded that this Court was not attempting to establish a rule that would extend to cases not involving a pro rata distribution, which was not what was involved in *Bedford.* See *Shimberg* v. *United States,* 577 F.2d at 290 & n.19; *King Enterprises, Inc.* v. *United States,* 418 F.2d at 520; *Hawkinson* v. *Commissioner,* 235 F.2d at 750-751; *Ross* v. *United States,* 173 F. Supp. at 797. The IRS has also rejected this broad reading of *Bedford.* See Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121. Because the present case involves a pro rata distribution of boot, the court of appeals erred in suggesting (App., *infra,* 11a-12a) that the government's contention here seeks to "resurrect[ ] the abandoned automatic dividend rule of *Bedford.*"

stock in the two old companies for stock in Omni, the superintendent would purchase additional shares of Omni and Omni would issue a promissory note to Wright. This promissory note was boot, and the court of appeals rejected the Commissioner's contention that it had the effect of a dividend. The court noted that "[t]he corporations involved did not exist separately but were owned and controlled by the same shareholders but in different proportions" (*id.* at 607). On that basis, the court concluded that "the note was issued by Omni in exchange for a portion of Omni stock that the taxpayer would have received if he had taken Omni stock entirely instead of receiving Omni stock and a note issued to him by Omni" (*ibid.*). The court then applied the provisions of Section 302 to measure the effect of this hypothetical redemption on Wright's interest in Omni and concluded that there was a meaningful reduction in his percentage interest that precluded dividend treatment.

The Fifth Circuit in *Shimberg* recognized that *Wright* was distinguishable because the commonality of ownership of the merging corporations appeared to be the basis upon which the Eighth Circuit had concluded that the distribution of boot should be treated like a redemption of shares in a single corporation. The Fifth Circuit therefore remarked (577 F.2d at 287): "Even assuming that *Wright* is correctly decided—a point on which we express no opinion—the instant case presents radically different facts and calls for correspondingly different analysis." That observation is equally applicable here. For this reason, the court of appeals below clearly erred in applying the "hypothetical redemption" approach of *Wright* to this case, rather than the long line of authority requiring dividend treatment for boot distributed to the shareholders of one corporation on a pro rata basis.

4. In the words of the Fifth Circuit in *Shimberg*, it was error for the court below to embrace "the undifferentiating invocation of stock redemption principles in a reorganization case such as this one" (577 F.2d at 287). To be sure, there is considerable similarity between the redemption provisions and Section 356(a)(2) ~~and the redemption context~~; both involve an inquiry into whether a particular non-dividend distribution is sufficiently akin to a dividend that it should be treated as one for tax purposes. At the same time, there are significant differences between the two contexts to which these provisions apply—for example, the difference between a transaction involving a shareholder and a single corporation as opposed to a consolidation involving two, often unrelated, corporations. These differences are substantial enough to counsel against the incorporation of every nuance and detail of Section 302 into the inquiry needed under Section 356(a)(2).

In any event, in the context presented here, there is no tension between the principles of Section 302 and the principles that should be applied under Section 356(a)(2). As discussed above, a pro rata payment of boot should be treated as a dividend. A distribution to a sole shareholder, as in this case, is necessarily pro rata. By the same token, a pro rata redemption of stock, including the redemption of some of the shares of a sole stockholder, is essentially equivalent to a dividend and therefore taxable as a dividend under Section 302(d). See *United States* v. *Davis*, 397 U.S. 301 (1970). In short, a pro rata payment of cash is the prototype transaction calling for dividend treatment in both the reorganization and redemption contexts. This case, therefore, presents no occasion to consider to what extent the detailed formulations of Section 302 should be applicable in the case of boot that is not distributed on a pro rata basis or whether, in such circumstances, a different result could obtain under Section 356(a)(2) from what would be indicated by Section 302.[12]

---

[12] The court in *Shimberg* noted that it did not totally reject the relevance of redemption principles in the context of a reorganization (577

The court below concluded that the application of redemption principles in the post-reorganization setting yielded capital gain treatment of boot distributed to a sole shareholder. It could reach this conclusion only by assuming, contrary to fact, that respondent had elected the choice that he consciously rejected, namely, receiving, 425,000 shares of NL stock and no cash. The court then applied Section 302 to the hypothetical redemption of 125,000 of those shares and concluded that the diminution in respondent's interest in NL was sufficiently substantial to make the redemption (and hence the receipt of boot) not equivalent to a dividend.

This approach is seriously flawed. First, it is generally true that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice," not of the alternative that he did not choose. *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). See also *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569, 579-580 (1977). In addition, the approach of the court below creates substantial practical difficulties because it requires a determination of how many shares the taxpayer would have received instead of the boot if the transaction had been a stock-for-stock reorganization followed by a redemption. That determination happened to be easy in this case because of the fortuity that respondent had been offered two alternatives. In cases that lack this unusual aspect, and that involve difficult-to-

F.2d at 290). By the same token, the Commissioner has stated that the principles developed under Section 302 for determining dividend equivalency may "in appropriate cases" serve as "useful guidelines for purposes of applying § 356(a)(2)." Rev. Rul. 74-516, 1974-2 C.B. 121. But these principles come into play only in the context of a non-pro-rata distribution; otherwise, the payment is clearly a dividend. Thus, they have no application here. For this reason, the example of a non-pro-rata distribution that the court of appeals put forth as demonstrating a flaw in the Commissioner's position (see App., *infra*, 12a) was quite irrelevant.

value close corporations, it will be quite difficult to construct the hypothetical redemption required by the court of appeals.

Moreover, the decision below is flawed because it seeks to equate two transactions that differ in a number of important respects. If respondent had actually elected to receive all of the consideration in the form of NL stock and then redeem a portion of it, the basic accounting figures generated by the transaction would not have been the same. The total basis of the stock received by respondent in the merger, which derives from the basis in the old stock he exchanged, must be allocated over the total number of shares received. Thus, the basis of each individual share obviously is going to be different depending upon whether the total basis is allocated over the 300,000 shares actually received in the merger or over the 425,000 shares that would have been received in the transaction assumed by the court of appeals. And, because the gain recognized on a redemption is reduced by the basis of the redeemed shares, the gain recognized if respondent had chosen the "no cash option" would have been different from the gain recognized on the actual transaction involving boot.

Another difference between the two transactions is the effect on the earnings and profits accounts. In the actual transaction, the earnings and profits available for distribution as a dividend were Basin's $2,319,611 in accumulated earnings and profits. If respondent had chosen the redemption option, however, the earnings and profits would have been those of NL (a figure that is not in the record here and that, in any event, bears no relation to Basin's or respondent's history).[13] And the effect on earnings and profits is not the same under Section 356(a)(2) as

[13] Because Basin did not merge into NL, but rather into its subsidiary, NLAC, Basin's earnings and profits would not be involved in the redemption of NL stock.

it is in the case of redemptions. In the former case, the statute specifically provides that the available account is limited to *accumulated* earnings and profits. In the case of a redemption, the earnings and profits of the taxable year are also available (see *Estate of Uris* v. *Commissioner,* 605 F.2d 1258 (2d Cir. 1979); *Baker* v. *United States,* 460 F.2d 827, 832-835 (8th Cir. 1972)), and a portion of the redemption would have drawn upon a share of NL's capital (see *Foster* v. *United States,* 303 U.S. 118 (1938)). These significant differences cast considerable doubt upon the validity of a doctrine that assumes that the two transactions are equivalent.

In sum, respondent presumably acted prudently and according to his best judgment in choosing to take cash and stock upon the merger of his corporation into NLAC, rather than committing substantially all of his resources to a large corporation in which he would be a minority shareholder (see note 2, *supra*). The court below erred in relieving him of the tax consequences of that choice and instead giving him the tax consequences of the option that he declined. The court should have followed established precedent and treated the boot actually received as a dividend to the extent of Basin's earnings and profits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

DONALD B. AYER
*Acting Solicitor General**

WILLIAM S. ROSE, JR.
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

ERNEST J. BROWN
Attorney

JANUARY 1988

---

* The Solicitor General is disqualified in this case.

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 86-1736

DONALD E. CLARK; PEGGY S. CLARK, PLAINTIFF-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
DEFENDANT-APPELLANT

Appeal from the United States Tax Court. Judge Tannenwald, Tax Court Judge. (Tax Ct. No. 9428-83)

Argued: June 3, 1987
Decided: September 4, 1987

Before: HALL and WILKINSON, Circuit Judges, and SMALKIN, United States District Judge for the District of Maryland, sitting by designation.

WILKINSON, Circuit Judge:

In April 1979, Donald Clark sold his company to N.L. Industries for 300,000 shares of N.L. stock and $3,250,000 in a transaction that qualified as a reorganization. The issue in this case is whether the cash payment, commonly called boot, should be taxed as a capital gain or as ordinary income. The Commissioner treated the boot as ordinary income, characterizing it as a dividend paid by Clark's company immediately before the reorganization. This characterization, however, fails to recognize that the

cash was an integral part of the reorganization. Rather than artifically separating the stock and the cash portions of the reorganization, we must examine the transaction in its entirety. We regard the boot as a cash payment by N.L. in return for Clark's relinquishment of a portion of his interest in the newly reorganized corporation. Because Clark surrendered more than 20% of his interest in N.L., he is entitled to capital gain treatment.

I.

Clark was the sole shareholder of Basin, a West Virginia corporation that supplied electronic, radiation, and nuclear open-hole logging services to the petroleum industry. In 1978, N.L. Industries, a public company listed on the New York Stock Exchange, initiated negotiations with Clark over the possible acquisition of Basin. N.L. eventually offered to buy Clark's stock for either 425,000 shares of N.L. or 300,000 shares and $3,250,000. Clark accepted the combination offer.

In April 1979, Clark and N.L. finalized the deal by signing an agreement in which Basin was merged with NLAC, a subsidiary of N.L. created for acquisition purposes. Because Clark and the Commissioner have stipulated that the transaction qualified as a reorganization under 26 U.S.C. § 368(a)(1)(A) and § 368(a)(2)(D), Clark did not have to report any gain on the exchange of his Basin stock for N.L. stock. Section 356(a), however, requires Clark to pay tax on the $3,250,000 cash payment to the extent of his gain in the transaction.

Clark and the Commissioner disagree on whether the cash payment should be taxed as a capital gain or ordinary income. Clark reported the boot as capital gain, but the Commissioner found that the cash payment had the effect of a dividend and should be taxed as ordinary income

to the extent of Clark's ratable share in Basin's earnings and profits. After the Service assessed a deficiency of $972,504.74, Clark filed a petition with the Tax Court. In a unanimous reviewed opinion, the Tax Court held that the corporate boot should be treated as a capital gain. *Clark v. Commissioner*, 86 T.C. 138 (1986). The Commissioner appeals.

II.

According to § 356(a)(2), cash received during a reorganization is considered ordinary income if it has the effect of a dividend. In determining when corporate boot has the effect of a dividend, most courts have relied on the principle of § 302, which provides in part that a corporate distribution is a dividend unless the shareholder relinquished more than 20% of his corporate control and was less than a 50% shareholder after the transaction. Although the Commissioner notes several differences between § 302 and § 356, we believe that § 302 continues to provide the appropriate test for determining whether boot is ordinary income or a capital gain. Thus, if Clark surrendered more than 20% of his corporate interest in return for the cash payment, he is entitled to capital gain treatment.

Under § 356(a)(2), Clark must recognize the boot as ordinary income if it had the "effect of the distribution of a dividend." Section 356 does not define when a payment has the effect of a dividend. In *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), the Supreme Court initially suggested that any cash payment made during a reorganization would be treated as a dividend under § 356. This automatic dividend rule, however, was severely criticized by the commentators. *See, e.g.*, Darrel, *The Scope of Commissioner v. Estate of Bedford*, 24 Taxes 266 (1946);

Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965). The lower courts retreated from this absolute approach, *see*, e.g., *Hawkins v. Commissioner*, 235 F.2d 747, 750-51 (2d Cir. 1956); *King Enterprises, Inc. v. United States*, 418 F.2d 511, 520 (Ct. Cl. 1969); *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958), and the Commissioner eventually abandoned the *Bedford* approach in several revenue rulings. *See, e.g.*, Rev. Rul. 515, 1974-2 C.B. 118; Rev. Rul. 83, 1975-1 C.B. 112. In place of this automatic dividend rule, most courts have approached the corporate boot problem by focusing on the underlying principle of § 302.

Although § 302 deals with stock redemptions by a single corporation, the section does draw a fundamental distinction between a capital gain and ordinary income. The basic principle of § 302 is that a shareholder who receives cash in a pro rata corporate distribution must pay an ordinary income tax, but if the shareholder relinquishes a sufficient portion of his corporate control in return for the cash, he will receive capital gain treatment. *See* 11 U.S.C. § 302 (1982); *See also United States v. Davis*, 397 U.S. 301 (1970) (requiring capital gain treatment if the redemption caused a "meaningful reduction" in the shareholder's corporate control).

When a shareholder surrenders some corporate control in return for a cash distribution, he is entitled to capital gain rates because the transaction is essentially an exchange of his corporate control, rather than a simple pro rata distribution of corporate earnings and profits. Because it is difficult to determine when a shareholder has yielded a sufficient percentage of control, § 302(b) contains a safe harbor provision, which treats a redemption as a capital gain if the taxpayer surrendered more than 20% of his corporate interest and was not a majority shareholder, after the redemption. If the principle of § 302 applies in this case, the boot would be a capital gain only if Clark yielded a sufficient portion of his corporate control.

Section 302 does not explicitly apply in the reorganization context, but there are several persuasive reasons why § 302 should be used in determining whether boot is taxed as ordinary income. Sections 302 and 356 contain virtually identical language, with § 302 providing for ordinary income treatment if the redemption is "essentially equivalent to a dividend", while § 356 treats boot as ordinary income if it "has the effect of a distribution of a dividend." Based on this similarity, the courts have consistently held that the sections should be read *in pari materia*. *See, e.g., Wright v. United States*, 482 F.2d 600, 605 (8th Cir. 1973); *Hawkins*, 235 F.2d at 750; *Ross v. United States*, 173 F. Supp 793, 797 (Ct. Cl. 1959). *See also Shimberg v. United States*, 577 F.2d 283, 287 n.13 (5th Cir. 1978) (stating that § 302 applies in "appropriate cases.") Moreover, in discussing the Deficit Reduction Act of 1984, the House and Senate conference committee noted that the "principles of section 302 are applicable in testing for dividend equivalence under section 356." H. Rep. 861, 98th Cong., 2d Sess. 757, 845, reprinted in 1984 U.S. Code Cong. & Ad. News 1445, 1532. Most importantly, § 302 and § 356 address the same issue: when should a corporate distribution be treated as a dividend? Note, *Reorganization and Capital Gains—A Forgotten Concept?*, 41 U. Pitt. L. Rev. 291 (1980); Note, *Determining Dividend Equivalence of "Boot" Received in a Corporate Reorganization*, 32 Tax Lawyer 834 (1979).

Until this case, the Commissioner has apparently adopted the prevailing view that § 302 applies in the reorganization setting. *See, e.g., Wright*, 482 F.2d at 605; Rev. Rul. 515, 1974-2 C.B. 118; Rev. Rul. 83, 1975-1 C.B. 112. The Commissioner, however, has discovered several

differences between the two sections and now argues that § 302 does not apply. For example, the Commissioner notes that all cash received in a stock redemption is ultimately taxed at either capital gain or ordinary income rates, but the boot received in a reorganization is taxed only to the extent of the taxpayer's gain on the transaction, regardless of the size of the boot payment. In addition, if a redemption is a dividend under § 302, the shareholder must pay ordinary income to the full extent of the corporation's earnings and profits (E&P), but if the boot is a dividend, § 356 only requires the shareholder to pay ordinary income to the extent of his ratable share of the corporate E&P.

While the Commissioner has illustrated several important differences between the two sections, they are irrelevant in this case. As Clark notes, the differences relate only to the *amount* of the gain treated as a dividend, not to the *character* of the corporate distribution. Any potential problems created by the differences in the provisions can be avoided by using § 302 only to determine whether the boot had the effect of a dividend and relying on § 356 to evaluate what specific portion of the payment, if any, should be taxed as ordinary income. In return for abandoning the § 302 analysis, the Commissioner offers no realistic alternative, except perhaps a return to the abandoned rule that any pro rata distribution in a reorganization must automatically be treated as a dividend. Rather than ignore a code section that specifically addresses the same problem as § 356, we join the long line of courts that have applied § 302 in the reorganization context. *See, e.g., Wright*, 482 F.2d at 605; *Hawkins*, 235 F.2d at 751; *King Enterprises*, 418 F.2d at 520-21.

III.

Although § 302 provides that a boot payment is a capital gain if Clark relinquished enough corporate control, the section cannot resolve this case. The boot can be seen as affecting either Clark's interest in Basin or in N.L., with radically different tax treatment depending on whether the boot was paid before or after the reorganization. Because § 302 was designed to deal with a stock redemption by a single corporation, rather than a reorganization involving two companies, the section does not indicate which corporation Clark actually lost interest in. Based on the language and legislative history of § 356, the change-in-ownership principle of § 302, and the need to review the reorganization as an integrated transaction, we conclude that the boot should be characterized as a post-reorganization stock redemption by N.L. that affected Clark's interest in the new corporation. Because this redemption reduced Clark's N.L. holdings by more than 20%, the boot should be taxed as a capital gain.

The transaction in this case involved two steps: Clark received a $3,250,000 corporate distribution and exchanged his Basin stock for N.L. stock. The characterization of the corporate boot presents a problem primarily because these two steps can be combined into at least two plausible stories. In the first version, Clark received the $3,250,000 from Basin in a pre-reorganization distribution and subsequently merged his shrunken company with N.L. for 300,000 shares. Under this pre-reorganization view, the boot would be ordinary income because Clark was the sole shareholder of Basin. In the second version, Clark exchanged his Basin stock for 425,000 shares of N.L. stock and N.L. subsequently redeemed 125,000 shares for $3,250,000. Because this redemption reduced Clark's interest in N.L. by almost 30%, he would be entitled to capital gain treatment.

Of course, both of these hypothetical stories are slightly unrealistic. In the pre-reorganization view, Basin is treated as distributing over three million dollars to Clark, but no such distribution occurred. Under the post-view, Clark is seen as receiving 425,000 N.L. shares, an offer he refused, and then hypothetically redeeming 125,000 shares. Despite the flaws in each story, they represent the only realistic options. No matter how the story is told, the boot was received either before or after the reorganization. If the boot was paid by Basin before the reorganization, the appropriate question is whether the payment affected Clark's ownership interest in Basin. If the boot was received after the reorganization, the focus should be on how it reduced Clark's holdings in N.L. Industries. Each version has its theoretical arguments and judicial adherents. *See Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978) applying pre-organization view); *Wright v. United States*, 482 F.2d 60 (8th Cir. 1973) (applying post-reorganization view).

In determining which view is more appropriate, the starting point of analysis is the statutory language of § 356. Section 356(a)(2) provides that, if the boot is a dividend, the shareholder is taxed at ordinary income rates only to "his ratable share of the undistributed earnings and profits of the corporation." The Commissioner argues that if the boot is deemed to come from N.L., Clark would have to determine his ratable share of N.L.'s earnings and profits (E&P), a task that is both difficult and slightly unrealistic. Moreover, if the focus is on the E&P of the acquirer, the shareholders of a target company could receive a distribution that has the effect of a dividend and pay virtually no ordinary income tax if the acquirer has a low E&P account. Thus, the Commissioner argues that "the corporation" in § 356(a)(2) must be Basin and hence that a pre-reorganization perspective is envisioned in the statute.

We do not think this statutory language is nearly so clear as the Commissioner suggests. In fact, much of the language of § 356 supports an integrated view of the transaction. Section 356(a)(1) provides that if the transaction would have been a tax-free reorganization "but for the fact that *the property received in the exchange* consists not only of property permitted by section 354 or 355 . . . but also of other property or money, then the gain, if any, to the receipient shall be recognized." 26 U.S.C. § 356(a)(1) (1982) (emphasis added). At a minimum, this language indicates that a shareholder of the target corporation may receive cash from the acquiring company; the section also strongly implies that all property involved in the reorganization, both the stock and the boot; should be seen as coming from the acquirer in a single exchange. Hankin & Lerer, *Wright v. Wrong: The Final Solution to the Dividend Equivalency Problem*, 23 Santa Clara L. Rev. 1 (1983). The Commissioner's pre-reorganization view conflicts with this language because it invariably sees the boot as coming from the target corporation, thereby separating the boot payment from the exchange of stock.

The post-reorganization view of the language of § 356 is bolstered by the legislative history. In enacting § 112(c)(2) of the 1939 Code, the precursor of § 356(a)(2), Congress provided an example of when a distribution has the "effect of a dividend." In the example, shareholders of corporation A tried to withdraw the company's E&P by forming corporation B, transferring all the assets of the old corporation to this new corporation in a reorganization, and receiving as consideration some stock of B plus a cash payment. H. Rep. 179, 68th Cong., 1st Sess 15 (1924), 1939-1 C.B. (Pt. 2) 241, 252. The boot in that case should obviously be treated as a dividend: the shareholders have received corporate earnings in a pro rata distribution while retaining the same level of control in corporation B. As the

Tax Court properly noted, this example suggests that "the primary objective of Congress was to prevent shareholders from bailing out earnings and profits at capital gain rates when in essence the shareholders stood substantially in the same position before the reorganization as they did after the reorganization." 86 T.C. at 143. There is no evidence of such a bail-out in this case.

We cannot accept the Commissioner's view of the legislative history. According to the Commissioner, Congress enacted § 356 to ensure that corporate boot would be taxed as ordinary income if the distribution would have been a dividend without the reorganization. The Commissioner concludes that Clark should pay an ordinary income tax, even though his corporate control was affected by an acquisitive reorganization, because the boot would have been a dividend if paid by Basin absent the reorganization. This reading of the legislative history is unsupportable; there is no indication that Congress intended to impose virtually automatic dividend treatment on boot received during an acquisitive reorganization in which the shareholder of the target corporation relinquished a portion of his interest in the new corporation. Note, *Taxation of Boot Distributions: A Return to Bedford?*, 7 Hofstra L. Rev. 987 (1979); Note, *Treatment of Cash Distributions to the Shareholders Pursuant to a Corporate Reorganization: Shimberg v. United States*, 20 B.C.L. Rev. 601 (1979).

The principles underlying § 302 also support the post-reorganization view. The critical inquiry under § 302 is whether Clark lost any corporate control as a result of the transaction. Under the Commissioner's view, Clark lost no control because, after the redemption, he was still the majority shareholder of Basin. This version, however, fails to recognize that Basin ceased to exist immediately after the hypothetical distribution to Clark. An examination of Clark's pre-reorganization interest in Basin reveals

nothing about how much corporate control he retained after the reorganization was completed. An accurate evaluation of Clark's corporate interest for purposes of § 302 requires an examination of his holdings in N.L., which is the continuing corporation. Hurley, *Capital Gain Possibilities for Boot in Acquisitive Reorganizations Lessened by Shimberg Case*, 50 J. Tax'n 334 (1979).

IV.

In addition to finding scant support in the language and legislative history of § 356 and the rationale of § 302, the Commissioner's version of the transaction suffers from several serious flaws. First, as a practical matter, the Commissioner's view inexplicably favors shareholders of corporations which merge with larger corporations. Milner, *Boot under the Senate Finance Committee's Reorganization Proposal: a Step in the Wright Direction, But Too Far*, 62 Taxes 507 (1984). When a shareholder merges with a corporation listed on a major stock exchange, he can avoid ordinary income and virtually ensure capital gain treatment by taking only stock from the acquirer, waiting a sufficiently long time, and then selling the stock on the market as a capital gain. Note, *Boot Hill—Characterizing Property Distributed with Corporate Reorganizations*, 4 J. Corp. Law. 711 (1979). If, on the other hand, a shareholder merges with a closely held company, he may be forced to choose between taking only stock or receiving some cash and paying an ordinary income tax.

Second, the Commissioner's view comes close to resurrecting the abandoned automatic dividend rule of *Bedford*. *See* Note, 20 B.C.L. Rev. 601 (1979). The Commissioner's view will result in ordinary income treatment in most reorganizations because corporate boot is usually distributed pro rata to the shareholders of the target corporation. In cases where the target company has only one

shareholder, the Commissioner's rule would go even further and virtually guarantee dividend treatment because cash distributed to a sole shareholder will almost never result in a loss of corporate control and thus will almost always be deemed a dividend. The statutory language in § 356 clearly does not impose such automatic dividend treatment.

Third, the Commissioner's pre-reorganization perspective leads to anomalous results in some cases. Even the adherents of that view admit that the approach may be inappropriate when an individual owns stock in both the target and the acquiring corporation, as the following example illustrates: Shareholder A owns 30 of the 100 shares of corporation X, which is worth $100, and holds all 100 shares of corporation Y, also worth $100. Corporation X merges with corporation Y, creating XY corporation, a new company worth $200. As consideration for the merger, Shareholder A receives 110 shares of XY stock plus $20, instead of the 130 shares of XY stock he would have received in a pure stock-for-stock reorganization. The remaining shareholders of Corporation X receive only XY stock. When the reorganization is finished, A owns 110 of the 180 shares of XY stock and has $20. *See, e.g.*, Note, *Boot Distributions in Acquisitive Reorganizations: The Wright-Shimberg Controversy*, 59 S. Cal. L. Rev. 1295 (1980).

Under the pre-reorganization view, A would pay capital gain on the boot because he will be treated as if he redeemed 20 of his 30 shares in Corporation X for $20, immediately before the reorganization, thus falling within the § 302 safe harbor provision. Shareholder A, however, should pay ordinary income because he is the majority shareholder of the reorganized corporation. The intergrated view, by focusing on A's post-reorganization interest in the new company, would properly impose an ordinary income tax.

Fourth, as the Tax Court recognized, the leading case for the Commissioner's view, *Shimberg v. United States*, misconstrued the comparisons of shareholder interests required under an integrated view of the reorganization. 86 T.C. at 148-49; Note, 32 Tax Lawyer 834. *Shimberg* involved a "minnow-whale" reorganization, in which a small corporation merged with a larger corporation. The district court held that the shareholder of the target company satisfied the safe harbor provision of § 302 because he went from being the majority shareholder of the target to a less than 1% shareholder in the acquirer. As the *Shimberg* court noted, this approach would lead to a virtual automatic capital gain rule in minnow-whale reorganizations because the target shareholders will invariably fall with the § 302 safe harbor provisions. *Shimberg*, 577 F.2d at 287-88.

The *Shimberg* court was wrong to suggest, however, that an integrated perspective automatically provides for capital gain treatment. Rather than comparing the shareholder's interest in the target with his interest in the acquirer, the integrated view focuses on the shareholder's loss of interest in the acquiring corporation. If the boot does not reduce his ownership interest in the surviving corporation by the amount required in § 302, the shareholder must pay ordinary income.

Finally, the Commissioner's view artificially segments the Basin-N.L. reorganization. The step transaction doctrine, which encourages the view of transactions in their entirety, confirms our view that an integrated perspective is more appropriate. The classic exposition of the doctrine is *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), which also involved a choice between two plausible versions of a transaction. In *Zenz*, a shareholder redeemed a portion of his stock and sold the other portion to an outside buyer. The Commissioner argued that the redemption occurred first, which required the taxpayer to pay ordinary income

on the redemption. According to the taxpayer, the sale occurred first, which resulted in capital gain treatment for the redemption because it completely liquidated the shareholder's interest in the company. Both versions were theoretically plausible. *Zenz* noted that the overall effect of the sale and redemption was a complete elimination of the taxpayer's interest in the corporation, which should have entitled the taxpayer to a capital gain. 213 F.2d at 917. To ensure that the shareholder paid only capital gain rates, the court treated the transaction as if the sale occurred first, followed by a complete redemption.

This case presents the same problem faced by the *Zenz* court: determining which transaction—the redemption or the exchange of stock—occurred first. *Zenz* resolved the problem by focusing on the net effect of both steps in the transaction. The Commissioner here focuses on only one part of the transaction and fails to recognize that the cash and the stock exchange were integral parts of one reorganization. See, Levin, Adess & McGaffey, *Boot Distributions in Corporation Reorganizations*, 30 Tax Lawyer 287 (1977); Note, 59 S. Cal. L. Rev 1295; Note, 32 Tax Lawyer 834. The facts show that as a part of the reorganization, Clark was offered a choice between 125,000 shares of N.L. stock and $3,250,000. The cash that Clark chose was clearly a substitute for additional N.L. stock; the Tax Court found that "there is not the slightest evidence that the cash payment was a concealed distribution from Basin." 86 T.C. at 155.

The tax consequences of the transaction should reflect the reality of Clark's choice to forego 125,000 shares of N.L. stock. There is no question in this case that the value of the boot received was roughly equivalent to the value of the shares foregone by Clark. By taking the cash, Clark surrendered his potential interest in N.L. to the extent of almost 30%. This 30% drop satisfied the safe-harbor provisions of § 302 and entitled Clark to capital gain treatment.

The judgment of the Tax Court is *AFFIRMED.*

APPENDIX B

Docket No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Filed February 6, 1986

TANNENWALD, *Judge*: Respondent determined a deficiency in petitioners' Federal income taxes for the taxable year 1979 of $972,504.74. The sole issue for decision is whether the receipt by petitioners of cash (boot) as partial consideration under a plan of reorganization pursuant to sec. 368(a)(1)(A) and (a)(2)(D),[1] should be treated as a dividend pursuant to sec. 356(a)(2), instead of long-term capital gain under sec. 356(a)(1).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. This reference incorporates the stipulation of facts and attached exhibits.

Petitioners, husband and wife, resided in Buckhannon, West Virginia, at the time they filed their petition in this case. They timely filed a joint Federal income tax return for the calendar year 1979 with the Internal Revenue Service Center in Memphis, Tennessee.

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

For some time prior to April 18, 1979, petitioner husband Donald E. Clark (hereinafter referred to as petitioner) owned all the outstanding stock (58 shares) of Basin Surveys, Inc. (BASIN), a West Virginia corporation. BASIN's principal business was furnishing radiation, nuclear, and electronic open-hole logging services to the petroleum industry. Petitioner was the president of BASIN from 1964 until April 18. 1979.

N.L. Industries, Inc. (N.L.), is a New Jersey corporation engaged in the manufacturing and supplying of petroleum equipment and services, chemicals, and metals. NL is a publicly held corporation whose stock is traded on the New York Stock Exchange and the Pacific Stock Exchange. As of the end of March 1979, NL had outstanding approximately 32,533,000 shares of its single class of common stock (par value $2.50 per share) and 500,000 shares of preferred stock. N.L. Acquisition Corp. (NLAC) was a wholly owned subsidiary of NL.

In 1978, NL initiated discussions with petitioner regarding the possible acquisition of BASIN by NL. After several months of negotiations, on March 6, 1979, NL offered petitioner a choice between two alternatives: in exchange for petitioner's BASIN stock, NL was willing to give petitioner either (1) 425,000 share of NL common stock and no cash, or (2) a combination of 300,000 shares of common stock and $3,250,000 cash. Petitioner accepted NL's combined stock and cash offer. By accepting this offer, the total number of NL common shares outstanding increased to approximately 32,833,000 shares, and petitioner's stockholdings represented approximately 0.92 percent of that total. If petitioner had accepted the all-stock deal of 425,000 shares, the total number of NL common shares outstanding would have increased to approximately 32,958,000 shares, and petitioner's stockholdings would have represented approximately 1.3 percent of that total.

On April 3, 1979, an agreement and plan of merger (the plan) was executed by BASIN, NLAC, petitioner, and NL. The plan provided that on April 18, 1979, BASIN would merge with and into NLAC and that each outstanding share of NLAC would remain outstanding, each outstanding share of BASIN common stock would be exchanged for $56,034.482 cash and 5,172.4137 shares of NL common stock, and each share of BASIN common stock held in the treasury of BASIN would be canceled. The plan further provided that the articles of incorporation of NLAC would be amended to change its name to Basin Surveys, Inc. Moreover, pursuant to the plan, petitioner signed a covenant not to compete for 5 years and an employment agreement to remain with Basin Survey, Inc., for 3 years.

For the purposes of this case, the parties agree that the merger of BASIN into NLAC (the merger) was effected pursuant to, and qualified as a reorganization under, section 368(a)(1)(A) and (a)(2)(D). The closing price of NL common stock on the New York Exchange on April 18, 1979, was $23⅛ per share. Based on that closing price, the NL stock received by petitioner had a value of $6,937,500 which constituted 68.1 percent of the total value of the consideration which petitioner received for his BASIN stock. Prior to the merger, petitioners did not own any stock in NL or NLAC.

Petitioner's basis for his BASIN stock immediately prior to the merger was $84,515. He incurred expenses of $25,013 in connection with the merger. In their joint Federal income tax return for 1979, petitioners reported recognition of $3,195,294 of long-term capital gain as a result of the merger. As of April 18, 1979, BASIN had accumulated undistributed earnings and profits of $2,319,611, and total assets of $2,758,069 and liabilities of $808,132. Among its assets were $138,490 in cash, $1,231,552 in trade notes and accounts receivable (after

allowance for bad debts), and buildings and other fixed depreciable assets with a book value net of accumulated depreciation of $929,306.

OPINION

The issue for decision is whether the cash (boot) received by petitioner had the effect of a dividend under section 356(a)(2), and should therefore be taxed as ordinary income. Resolution of this issue requires us to choose between two judicially articulated tests (the so-called *Wright* test, *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), and the so-called *Shimberg* test, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. (1978)), in interpreting what is, at best, an ambiguous statute. Respondent argues that we should choose the *Shimberg* test and treat the $3,250,000 cash payment as if it constituted a distribution in redemption of stock by the *acquired* corporation (BASIN) prior to, and separate from, the merger. If this is our choice, then, according to respondent, since the redemption fails to satisfy the requirements of either section 302(b)(1) or (b)(2), the cash payment should be treated as a dividend from BASIN under section 356(a)(2) to the extent of its earnings and profits ($2,319,611), and as capital gain in respect of the excess.[2] Petitioner, on the other hand, urges us to choose the *Wright* test and treat the cash payment as a distribution by the *acquiring* corporation (NL) in a hypothetical redemption of the shares of NL stock that would have been received if petitioner had accepted stock in lieu of the cash consideration under the all-stock alternative available to him. Petitioner then argues that such a redemption would have resulted in a meaningful or substantially disproportionate reduction in

[2] Since the amount of the cash is not in excess of petitioner's gain from the exchange, the limitation of sec. 356(a)(1) does not come into play. We note that for the same reason, this limitation does not apply to the *Wright* test advocated by petitioner.

petitioner's stock interest in NL and that consequently, the entire $3,250,000 cash payment should be treated as a payment in exchange for NL stock, under section 302(a),[3] taxable as capital gain under section 356(a)(1). For the reasons hereinafter set forth, in the context of this case, we agree with petitioners.

The issue of choice is not a novel one, although as will subsequently appear, the number of judicial precedents is limited. It has spawned a large number of articles and commentaries of both an historical and analytical nature[4] dealing with the proper test to be used in applying section 356 to acquisitive reorganizations.[5] While we deem it un-

[3] The general rule of sec. 302(a) provides that "If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock."

[4] See Kyser, "The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)," 39 Tax L. Rev. 297 (1984), and citations collected at p. 299, nn. 14 & 15; Rands, "Section 356(a)(2): A Study of Uncertainty in Corporate Taxation," 38 U. Miami L. Rev. 75 (1983); Levin, Adess & McGaffey, "Boot Distributions in Corporate Reorganizations – Determination of Dividend Equivalency," 30 Tax Law. 287 (1977); Golub, " 'Boot' in Reorganizations – The Dividend Equivalency Test of Section 356(a)(2)," 58 Taxes 904 (1980); Comment, "Determining Dividend Equivalence of 'Boot' Received in a Corporate Reorganization," 32 Tax Law. 834 (1979). See also B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par 14.34, at 14-116 to 14-119 and S14-53 to S14-56 (4th ed. 1979 & Supp. 1985); D. Kahn, Basic Corporate Taxation, par. 10.51 (3d ed. 1981).

[5] Since sec. 368(a)(1)(E) (recapitalization) and (F) (mere change in identity, form, or place of organization) only involves a single corporation, a choice between the *Wright* test and the *Shimberg* test is not required. Similarly, in view of the "solely" requirement of sec. 368(a)(1)(B) (see *Heverly v. Commissioner*, 621 F.2d 1227 (3d Cir. 1980), revg. and remanding *Pierson v. United States*, 472 F. Supp. 957 (D. Del. 1979), and *Reeves v. Commissioner*, 71 T.C. 727 (1979); and

necessary to lay out a detailed, evolutionary history, a brief review of the statutory provisions and their historical genesis appears to be in order as a prerequisite to understanding the parameters of the choice we are called upon to make.

Sections 354 and 356 provide the tax treatment to be afforded shareholders of corporations which are parties to reorganizations qualifiying as such under section 368(a)(1). Specifically, under section 354(a)(1)–

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, *exchanged solely for the stock or securities in such corporation or in another corporation a party to the reorganization.* [Emphasis added.]

In situations in which the reorganization is not a straight stock-for-stock deal, but instead includes some additional consideration, the Internal Revenue Code (the Code) does not simply recategorize the entire transaction as a taxable exchange. Rather, it provides for a limited recognition of gain under section 356(a)(1)–

> (1) RECOGNITION OF GAIN.–If–
>
> (A) section 354 or 355 would apply to an exchange but for the fact that
>
> (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

---

Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980), revg. and remanding *Reeves v. Commissioner, supra*), there never should be any "boot" and hence no occasion for choice where a "B" reorganization is involved. See also *McDonald v. Commissioner,* 52 T.C. 82 (1969), where a choice was made because respondent erroneously conceded the existence of a "B" reorganization (see Rev. Rul 75-360, 1975-2 C.B. 110).

> then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

This gain is to be treated as a capital gain unless the exchange qualifies for dividend treatment under section 356(a)(2), which provides–

> If an exchange is described in paragraph (1) but *has the effect of the distribution of a dividend* * * * then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property. [Emphasis added.]

The precursor of section 356(a)(2) first appeared in the Revenue Act of 1924, which became, without significant change, section 112(c)(2) of the Internal Revenue Code of 1939. The following example, found in the report of the House Ways and Means Committee, is illuminating–

> The necessity for this provision may best be shown by an example: Corporation A has capital stock of $100,000, and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.
>
> On the other hand, Corporation A may organize Corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the stockholders of Corporation A in exchange for their stock in Corporation A. Under the existing law, the $50,000

> distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12½ per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the 12½ per cent rate on capital gain. Here again this provision prevents evasions.
>
> [H. Rept. 179, 68th Cong., 1st Sess. 15 (1924), 1939-1 (Part 2) 241, 252].

Thus, it appears that the primary objective of Congress was to prevent shareholders from bailing out earnings and profits at capital gain rates when in essence the shareholders stood substantially in the same position before the reorganization as they did after the reorganization, i.e., "to prevent the bailout of earnings and profits at capital gains rates through the device of a reincorporation reorganization." See Kyser, *supra* note 4, at 302.

In *Commissioner v. Estate of Bedford,* 325 U.S. 283 (1945), the Supreme Court ruled that any distribution of "boot" pursuant to a reorganization would have the effect of a taxable dividend to the extent of the corporation's accumulated earnings and profits, i.e., the so-called "automatic dividend rule." That decision met with much criticism, however (see, e.g., *Hawkinson v. Commissioner,* 235 F.2d 747, 750-751 (2d Cir. 1956)), and both the courts and the Internal Revenue Service have now retreated from the rule. See, e.g., *Shimberg v. United States,* 577 F.2d at 290; *King Enterprises, Inc. v. United States,* 189 Ct. Cl. 466, 418 F.2d 511, 520 (1969); *Johnson v. Commissioner,* 78 T.C. 564, 575-576 (1982); Rev. Rul. 74-515, 1974-2 C.B. 118, 120.

In its place, the courts have developed a concept which encompasses the determination of whether a distribution has "the effect * * * of a dividend" by looking to the provisions of section 302, although there is no express reference to that section in section 356(a)(2). Most of the courts have said that these two sections are to be read in pari materia. *Wright v. United States,* 482 F.2d at 605; *King Enterprises, Inc. v. United States,* 418 F.2d at 520; *Ross v. United States,* 146 Ct. Cl. 223, 173 F. Supp. 793, 797 (1959); *Hawkinson v. Commissioner, supra* at 751. The Fifth Circuit Court of Appeals, however, has adopted a somewhat more ambiguous approach by embracing and considering section 302 simply as providing " 'in appropriate cases' * * * 'useful guidelines for purposes of applying section 356(a)(2).' " *Shimberg v. United States, supra* at 287 n.13. (Citation omitted.) Although Congress has not chosen specifically to amend the Code to reflect the interrelationship of these two sections, its acquiescence and tacit approval of such a conclusion is apparent in the Conference Committee Report for the Deficit Reduction Act of 1984, in which it was unequivocally stated that "The principles of section 302 are applicable in testing for dividend equivalency under section 356." H. Rept. 98-861 (Conf.) (1984), 1984-3 C.B. (Vol. 2) 1, 99. Furthermore, the Internal Revenue Service has adopted this position in its published rulings.[6] In point of fact, the distinction between the "in pari materia" and the "useful guidelines" standard is little more than one of nuance and without any impact on the instant case since neither standard provides any significant help in making the choice before us.

Turning to section 302(b), we find two situations, insofar as relevant to the case before us, in which a distribution in redemption of stock is to be treated as a distribution in part or full payment in exchange for such stock and

---

[6] See Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121; Rev. Rul. 75-83, 1975-1 C.B. 112.

not as a dividend. Section 302(b)(1) provides for such treatment, i.e., capital gain under section 302(a), "if the redemption is not essentially equivalent to a dividend." The Supreme Court has held that for a redemption to meet this test it "must result in a meaningful reduction of the shareholder's proportionate interest in the corporation." *United States v. Davis*, 397 U.S. 301, 312 (1970). Section 302(b)(2)(A) provides for such treatment if the "distribution is *substantially disproportionate* with respect to the shareholder." (Emphasis added.) A distribution qualifies as being "substantially disproportionate" if the shareholder's interest in the voting stock and the common stock (whether voting or nonvoting) of the corporation immediately after the redemption is less than 80 percent of his interest in such stock immediately before the redemption, and if immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote. Sec. 302(b)(2)(B) and (C). If the shareholder falls within this "safe harbor" constructed by Congress, the redemption is deemed to be "substantially disproportionate."

The first case[7] directly to confront the issue of whether, in determining the application of section 356(a)(2), the tests under section 302 should be applied in the context of a redemption by the *acquired* or the *acquiring* corporation was *Wright v. United States, supra*, in which the Eighth Circuit Court of Appeals held that the proper test for determining whether the distribution had "the effect * * * of a dividend" was to view the cash payment as a reduction of the taxpayer's stockholdings in the *acquiring*, i.e., surviving, corporation. In Rev. Rul. 75-83, 1975-1 C.B. 112, however, the respondent expressly rejected the holding in *Wright* and said it would not be followed. Instead, respondent focused on the cash payment as a reduction of the taxpayer's stockholdings in the acquired corporation, prior to the reorganization. The Fifth Circuit Court of Appeals adopted a similar stance in *Shimberg v. United States, supra*, in which it also rejected the holding and reasoning of *Wright* as erroneously placing the emphasis on the surviving, instead of the acquired, corporation. See 577 F.2d at 287.

[7] In *King Enterprises, Inc. v. United States*, 189 Ct. Cl. 466, 418 F.2d 511 (1969), there was no dispute that the dividend determination should be made with reference to the acquired corporation. See 418 F.2d at 521. In *Ross v. United States*, 146 Ct. Cl. 223, 173 F. Supp. 793 (1959), the Court of Claims thought the facts of that particular case so clear that it had no choice but to find that the distribution was made by the acquired corporation. *Hawkinson v. United States*, 235 F.2d 747 (2d Cir. 1956), seemingly determined dividend equivalency in terms of a distribution from the acquired corporation but clearly did not confront the issue of choice between the acquired and the acquiring corporation. See also pp. 151-152, and particularly *infra* note 15, discussing *McDonald v. Commissioner*, 52 T.C. 82 (1969).

Wright v. United States, supra, involved the consolidation of two closely held corporations into a new corporate entity (Omni). The old corporations were commonly owned, but in different proportions. A simple merger involving the exchange of shares of these corporations for shares of Omni would not have resulted in the ownership percentages in Omni desired by the controlling shareholders. As a result, pursuant to the reorganization, "boot," in the form of a promissory note, was paid to the majority stockholder to compensate him for taking a reduced equity interest in Omni.

In determining dividend equivalency, the Eighth Circuit first focused on who in fact issued the note constituting the "boot," i.e., the old corporations or Omni. While recognizing that "it is not material whether the distribution is actually made by the corporation entering the reorganization or by the corporation resulting from the reorganization," the court emphasized that it could not ignore "the factual circumstance that there were two corporations * * * before reorganization and one after reorganiz-

ation." 482 F.2d at 607. The court found that, within the context of the entire plan of reorganization, it was artificial for respondent to contend that the note was issued by the old corporations. Instead the court held that "the note was issued by Omni in exchange for a portion of Omni stock that the taxpayer would have received if he had taken Omni stock entirely instead of receiving Omni stock and a note issued to him by Omni." 482 F.2d at 607. The court concluded that the rationale underlying the redemption provisions mandated such a result—

> The entire concept of a redemption contemplates a change in ownership between an ongoing corporation and a newly formed corporation or within an ongoing corporation itself. For example, underlying the "safe harbor" provision, sec. 302(b)(2), is the rationale that a substantially disproportionate redemption of stock leads to the conclusion that the exchange is a redemption. The percentage requirements, e.g., the 50 per cent rule, refers to the necessity of having 50 per cent of the total voting stock *after redemption*. This rule and other redemption provisions make sense only in relation to a corporation that will continue to exist. If a substantially disproportionate redemption of stock has occurred the distribution clearly can be said to be a sale rather than a dividend because the stockholder has relinquished valuable rights in the future business. Further, the rights of stock ownership—to vote, to participate in earnings, and to share in net assets on liquidation—are all affected by a redemption. But these rights and the effect of a redemption only make sense in relation to a corporation that will be engaged in doing business after the redemption. To analyze the present case as a redemption of [the old corporations'] stock alone * * * is an artificial reading of the redemption provisions, for [the old corporations] were dissolved as part of the Plan. The

> change in ownership that would be significant due to a redemption would be a change in ownership in Omni, the corporation that would exist after the redemption and would have voting stock, earnings, and assets that would be affected. [482 F.2d at 607-608. Emphasis supplied.]

In *Shimberg v. United States, supra*, the Fifth Circuit Court of Appeals was faced with a factual set of circumstances similar to the instant case. The taxpayer in that case owned approximately 67 percent of a LaMonte-Shimberg Corp. (LSC), of which he was president and chief executive officer. Pursuant to a plan of reorganization, LSC was merged into a large publicly held corporation called MGIC Investment Corp. (MGIC) whose stock was traded on the New York Stock Exchange. According to the terms of the merger, the stockholders of LSC received ratably, in exchange for all their LSC stock, stock of MGIC and cash "boot" of $625,000. The taxpayer received $417,449 in cash and stock in MGIC constituting less than 1 percent of MGIC's total shares outstanding. Immediately prior to the merger, LSC had undistributed earnings and profits in excess of $625,000.

As in *Wright*, the issue before the Fifth Circuit was whether the taxpayer's receipt of cash "boot" had the effect of a dividend distribution. The District Court had found for the taxpayer, basing its decision on an apparent misinterpretation of the holding in *Wright*. *Shimberg v. United States*, 415 F. Supp. 832 (M.D. Fla. 1976). After a preliminary discussion of the Eighth Circuit's application of the *Davis* "meaningful reduction" test in *Wright*, the District Court concluded that the taxpayer's relinquishment of ownership and control of a small, local company in exchange for a "miniscule percentage of the outstanding stock of a huge, publicly-held corporation [made it] * * * clear that the merger resulted in a radical change and

meaningful reduction in the nature of the [taxpayer's] interest in the continuing business." 415 F. Supp. at 836. Thus, rather than focusing solely on the taxpayer's interest in the surviving corporation, the District Court misconstrued *Wright* to mean that the proper test for determining dividend equivalency was a comparison between the taxpayer's interest in the acquiring, i.e., surviving, corporation after the reorganization and the interest he held prior to the reorganization in the acquired corporation.

The Fifth Circuit Court of Appeals reversed, finding that the District Court's application of the "meaningful reduction" test of section 302(b)(1) was incorrect and that the "undifferentiating invocation of stock redemption principles in a reorganization case such as this is erroneous." 577 F.2d at 287. It is apparent that the Court of Appeals predicated its rejection of the lower court's holding on its mistaken view that the District Court had properly interpreted and applied the *Wright* test. This is clearly borne out by the court's finding that—

> A contrary holding would render section 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations. And, even in that situation, disproportionate ownership—as in *Wright*—could result in a meaningful reduction. [577 F.2d at 288.[8]]

[8] The Fifth Circuit's misunderstanding of the *Wright* holding is even more clearly evidenced in *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980). In that case, pursuant to a plan of reorganization qualifying as such under sec. 368(a)(1)(C), the two shareholders of Olivier Co., Inc. (Olivier), who held two-thirds and one-third of its stock, respectively, received pro rata cash payments and stock of U.S. Industries (USI), constituting 0.4 percent and 0.2 percent, respectively, of the total outstanding stock of USI. The Fifth Circuit, in discussing the decision in *Wright*, stated—

> "Here, if the *Wright* test were applicable, we would be concerned with a reduction from a 66⅔% and 33⅓% interest in Oliver stock for [the two shareholders] respectively to a 0.4% and 0.2% respective interest in the outstanding USI stock. [615 F.2d at 1066.]"

Once again, the Fifth Circuit misinterpreted the *Wright* test as comparing shareholder interests in the old corporation to those in the surviving corporation.

Having rejected the District Court's analysis, the Fifth Circuit reasoned that, according to the theory and legislative history behind the reorganization provisions "section 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred." 577 F.2d at 288. It then concluded that, since absent the reorganization, a pro rata distribution of $625,000 to LSC shareholders would have been a dividend taxable as ordinary income, "The taxpayer should not be able to reap the benefits of capital gain treatment simply because he received his share of the distribution after the merger in the form of a 'boot' rather than before the merger in the form of a dividend." 577 F.2d at 289.

After careful consideration, we have concluded that, at least in the context of the factual situation before us, the *Wright* test is the better choice in respect of the application of section 302 to the determination of whether "boot" has "the effect of the distribution of a dividend" under section 356(a)(2). Several considerations have led us to this conclusion.

The genesis of section 356(a)(2) (see p. 143 *supra*), lay in Congress' concern for the possibilities of manipulated withdrawals within the framework of reorganizations which approached the types of transactions which have been dealt with in later years through the application of

the liquidation-reincorporation doctrine. See B. Bittker & J. Eustice, supra note 4, par. 14.54.[9]

While we recognize this clear intent by Congress to prevent abusive cash bailouts made pursuant to planned reorganizations, as well as the fact that the language used in section 356(a)(2) may have been broader than necessary to deal with the legislative concern, contrary to respondent's position we do not think it follows that we must test "boot" distributions in connection with a reorganization, as if they were made by the acquired corporation prior to and separate from the reorganization. As we have noted in the past, in legitimate reorganizations that substantially reduce a shareholder's ownership interest, although it may be true "that a decision in favor of the petitioner would allow him to withdraw substantial corporate earnings at no tax (or, if his basis in the redeemed stock were less than the amount distributed, at capital gains rates) * * * such result does not require us to hold that the distribution is a dividend." *McDonald v. Commissioner*, 52 T.C. 82, 89 (1969).

Respondent asks us to follow a twisted path. After conceding that the distribution has been made pursuant to a legitimate reorganization under section 368(a)(1)(A), a necessary prerequisite to invoking section 356(a)(2), respondent then asks us to make our determination of dividend equivalency fantasizing that the reorganization does not exist.[10] Clearly, if Congress had wanted the

[9] Subsequent legislative history is of little help in resolving the choice issue. Proposals in 1954 and 1959 seem to have embraced respondent's position herein while more recent proposals embrace the position espoused by petitioner; none of these proposals have been adopted. See Kyser, *supra* note 4, at 322-323; Rands, *supra* note 4, at 93-94; Golub, *supra* note 4, at 905-906; B. Bittker & J. Eustice, *supra* note 4, at S14-51 to S14-56.

[10] See *supra* note 9 for the conflicting attempts by Congress to deal with the choice issue.

distribution to be viewed in this manner, it could easily have said so in 1924 or in connection with the passage of numerous revenue acts in the ensuing 60 years.[11]

We reject respondent's attempt to bootstrap the holdings that the acquired corporation's earnings and profits should be the measure of any dividend under section 356(a)(2) into a conclusion that the determination of the requisite reduction in interest under section 302(b) must be necessarily made with reference to the same corporation. In our opinion, there is no such necessary correlation. There is no reason why the redemption cannot be considered as having been made by one corporation with the consequences to be measured by the earnings and profits of another corporation. Compare section 304(b)(1) with section 304(b)(2)(A). Moreover, the courts are not in agreement as to the standard of measurement to be used. See *Atlas Tool Co. v. Commissioner*, 70 T.C. 86, 106-107 (1978), affd. 614 F.2d 860, 868 (3d Cir. 1980).[12] Indeed, respondent on brief has made it clear that his acceptance of the agreed stipulation of the parties that the earnings and profits of BASIN will be the measure of any dividend determined herein is not to be construed as an acceptance of this test in any other case.

Respondent's attempt to view the cash payment as an isolated event totally separate from the reorganization runs counter to the established case-law principle known as the "step-transaction" doctrine—a doctrine which respondent has zealously and generally successfully sought to apply in the reorganization arena. See Levin, Adess & McGaffey, *supra* note 4, at 290; Rands, *supra* note 4, at 117. In *McDonald v. Commissioner, supra*, we held that

[11] Furthermore, the limitation of dividend treatment contained in sec. 356(a)(2) is a clear indication that Congress considered the boot distribution to be an integral element of the reorganization. See Levin, Adess & McGaffey, *supra* note 4, at 303.

[12] See also *Davant v. Commissioner*, 366 F.2d 874, 887-890 (5th Cir. 1966), revg. on this issue *South Texas Rice Warehouse Co. v. Commissioner*, 43 T.C. 540, 570-572 (1965); *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 230-231 (1970).

the "step-transaction" doctrine, first set forth in *Zenz v. Quinlivan* 213 F.2d 914 (6th Cir. 1954),[13] was "applicable in determining whether a redemption is essentially equivalent to a dividend within the meaning of section 302(b)(1)," 52 T.C. at 87. The facts in *McDonald*, simply stated, are as follows. Taxpayer owned 10 of the 11 shares of the common stock of E & M Enterprises, Inc. (E&M), and all of its preferred stock. Pursuant to a plan of reorganization, E&M redeemed all of taxpayer's preferred stock for $43,500, and Borden Co. (Borden), the corporation acquiring E&M, gave 4,839 of its shares in exchange for the 11 shares of E&M common stock. E&M acquired the cash to carry out the redemption by obtaining a short-term bank loan. A week after the redemption, E&M and Borden exchanged their shares and Borden transferred cash to E&M which was used in part to pay off the loan. Respondent argued that the redemption by E&M of taxpayer's preferred stock was a totally separate transaction and thus taxable as a dividend.[14] In holding for the taxpayer, we recognized that "The record in this case establishes clearly that the *redemption was merely a step in the plan of Borden for the acquisition of E&M, so that it is the results of the plan that are significant to us.*" 52 T.C. at 87 (emphasis added). We concluded that "Taking into account all the circumstances of this case * * * the redemption and the reorganization effected such a substantial change in the petitioner's interest in E&M as to establish that the redemption was not essentially equivalent to a dividend." 52 T.C. at 89.

[13] The taxpayer in *Zenz* wished to sell all the stock in a corporation in which she was the sole stockholder. To satisfy the wishes of the purchaser who did not want to buy all the stock of the corporation, the parties agreed upon a plan under which the purchaser bought part of the stock and the corporation redeemed the remaining shares. The court viewed the steps in the transaction as part a single integrated plan intended to totally liquidate the taxpayer's holdings in the corporation. In light of this, the court held that redemption was not essentially equivalent to a dividend because it completely terminated her interest in the corporation. See 213 F.2d at 917.

[14] It should be noted that, at trial, respondent considered the redemption and exchange to be separate transactions and therefore conceded that the exchange constituted a tax-free reorganization under sec. 368(a)(1)(B). 52 T.C. at 86. However, in Rev. Rul. 75-360, 1975-2 C.B. 110, the respondent recognized that –

> "it was in error in arguing the various steps were separate transactions thereby affording tax-free treatment on the stock exchange. Accordingly, since the acquisition was not solely for voting stock of the acquiring corporation, but partly for cash, that the acquisition of stock of E&M did not constitute a reorganization. Therefore * * * the entire transaction is considered a taxable sale or exchange."

We recognize that some argument can be made that the same failure to apply the step-transaction doctrine exists in applying the *Wright* test in that such test involves viewing the cash payment as being in redemption of an imputed number of shares of the acquired corporation after the reorganization has occurred. See Rands, *supra* note 4, at 102-103. But we think this argument fails in that the *Wright* test treats the cash payment as the equivalent of a redemption *in the course of implementing the reorganization*, while the *Shimberg* test, advocated by respondent, requires that the redemption by the acquired corporation be treated as having occurred *prior to and separate from the reorganization*. Clearly, the cash payment in situations of the type involved herein would not have taken place without the reorganization. The same cannot be said of the redemption created by the *Shimberg* test.

In view of the foregoing, we conclude that the determination of whether the cash payment to petitioner had "the effect * * * of a dividend" should be viewed and tested within the context of the entire reorganization. To hold otherwise, and view and test the cash (boot) as if it were distributed as a hypothetical redemption by BASIN prior to the reorganization, would in effect resurrect the

now discredited "automatic dividend rule" (see pp. 143-144 *supra*), at least with respect to pro rata distributions made to an acquired corporation's shareholders pursuant to a plan of reorganization.

We turn now to the question whether petitioner, as a result of the reorganization, suffered a reduction in interest sufficient to qualify the cash he received as a redemption under section 302(b). In resolving this question, we apply the test enunciated in *Wright v. United States, supra*, and look at the effect of the reorganization on petitioner's potential and actual interest in NL, the acquiring, i.e., surviving, corporation.[15]

Pursuant to the plan, petitioner received 300,000 shares of NL common stock, which constituted approximately 0.92 percent of the total shares outstanding of NL common stock after the merger. If petitioner had accepted the all stock offer, he would be received 425,000 shares of stock, which would have constituted approximately 1.3 percent of NL's total shares outstanding. By treating the cash "boot" as a redemption of petitioner's shares, we find that the cash distribution reduced petitioner's interest in NL by approximately 29 percent (from 1.3 percent to 0.92 percent) so that his post-distribution holdings were only approximately 71 percent of what they would have been absent the distribution. Coupled with the fact that petitioners held less than 50 percent of the voting stock of NL after the redemption, under section 302(b)(2) the distribution qualifies as being "substantially disproportionate" and is not taxable as a dividend. Since the distribution falls within the mechanistic "safe harbor" of section 302(b)(2), we need not decide if the redemption resulted in a meaningful reduction of petitioner's stock interest under section 302(b)(1).

[15] We recognize that it is possible to construe our opinion in *McDonald v. Commissioner*, 52 T.C. 82 (1969), as adopting a test based upon a comparison of a taxpayer's stock interest in the acquiring corporation with his prior interest in the acquired corporation. However, we think it significant that *McDonald* was decided prior to either *Wright* or *Shimberg*, that the issue before this Court was simply whether the redemption was separate from, or an integral part of, the reorganization, and that it appears that the acquired versus acquiring corporation test for applying sec. 356(a)(2) was not presented to us. Such being the case, and particularly since the result in *McDonald* would have been the same under the *Wright* test, we do not view our opinion in *McDonald* as inhibiting our freedom to choose the test which should be applied herein.

In point of fact, respondent does not argue that the required reduction in petitioner's interest does not exist if the *Wright* test is applied. Rather, the heart of respondent's position is that use of the *Wright* test results in an "automatic capital gain" rule. Respondent argues that, in cases involving factual circumstances similar to the instant case, in which the "whale" swallows the "minnow" and gives the shareholders of the acquired corporation a pro rata distribution of boot in addition to stock, those shareholders will always be afforded capital gain treatment. He reasons that if a shareholder in a small closely held corporation exchanges his interest in that corporation for what must be, almost by definition, a much smaller percent of ownership in a large publicly held corporation, a comparison of these percentage ownership figures will always be so disparate as to qualify as a meaningful reduction or as substantially disproportionate in the context of a redemption by the acquiring corporation. In effect, respondent's position is rooted, as was that of the District Court in *Shimberg v. United States*, 415 F. Supp. 832 (M.D. Fla. 1976), in an erroneous equating of the *Wright* test with a comparison of a taxpayer's interest in the acquired corporation before the reorganization with his interest in the acquiring corporation after the reorganization. See pp. 147-150 *supra*. We think we have made it clear that the *Wright* test does no such thing. It simply compares the stock interest which a taxpayer actually receives in the acquiring, i.e., surviving, corporation in a

reorganization with what he would have received if he had obtained additional stock in lieu of the cash payment. Whether the results of such a comparison indicate dividend or capital gain treatment will vary, depending on the facts and circumstances of each individual case. We think it significant that respondent in substance accepts the facts and circumstances limitation in situations involving section 356(a)(2).[16] In so doing, he reflects the same uncertainties as those of the Fifth Circuit in *Shimberg v. United States, supra*—uncertainties which, in a sense, are also present in our reservation of the same limitation in adopting the *Wright* test.[17]

[16] We quote from respondent's brief (p. 27):

"We are only addressing in this brief a factual situation which is identical to the one present in *Shimberg* where a small corporation (the "minnow") was merged into a large corporation (the "whale"), there had been no previous commonality of ownership between the two corporations, the "minnow's" shareholders received cash and stock on a pro rata basis, the "minnow's" shareholders stock ownership in the "whale" was very small vis-a-vis the number of shares outstanding, and the acquired corporation had a significant amount of accumulated undistributed earnings and profits."

In connection with the facts and circumstances limitation, we observe that respondent objected at trial to the relevancy of any testimony regarding the merger negotiations. We overruled respondent's objection and reserved to respondent the right to argue the question of admissibility on brief. We are satisfied that we should adhere to our ruling at trial. See *McDonald v. Commissioner*, 52 T.C. 82, 88 (1969).

[17] It is interesting to note that the Court of Appeals in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), would have reached a different conclusion if the attribution rules of sec. 318(a) had been applied. See 482 F.2d at 610. See also Kyser, *supra* note 4, at 312 n. 78. Under sec. 227(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 96 Stat. 324, 492, the attribution rules of sec. 318 now apply to "boot" payments falling within sec. 356(a).

While we are satisfied that the *Wright* test should not be equated with the comparison erroneously made by the District Court in *Shimberg v. United States, supra*, we think that the minnow-whale scenario is a background element which can be taken into account. Cf. *McDonald v. Commissioner, supra*. See also *supra* note 15.

If we look at the particular facts and circumstances of the instant case, the correctness of our conclusion that the cash distribution of $3,250,000 did not have "the effect * * * of a dividend" under section 356(a)(2) becomes even clearer. There is not the slightest evidence that the cash payment was a concealed distribution from BASIN.[18] Indeed, it is hard to conceive that such a possibility could even have been considered, for a distribution of that amount was not only far in excess of the accummulated earnings and profits ($2,319,611), but also of the total assets of BASIN ($2,758,069). In fact, only if one takes into account unrealized appreciation in the value of BASIN's assets, including good will and/or going-concern value, can one possibly arrive at a $3,250,000. Such a distribution could only be considered as the equivlalent of a complete liquidation of BASIN, which would call for capital gain treatment under *Zenz v. Quinlivan, supra*. Moreover, the record herein makes it clear that it was NL which developed the stock plus cash alternative and that its foundation was attributable to a desire of NL to minimize the number of shares outstanding. In this connection, we think that the question of whether the shareholders of the acquired corporation are given a choice

[18] It is in this context that the facts and circumstances analysis might well produce a different result when there is persuasive evidence of an identity between the amount of the cash payment, the earnings and profits of the acquired corporation, and available liquid assets to support the conclusion that the acquiring corporation was a conduit for the payment. Cf. *Ross v. United States, supra* note 7. The problem of identification of the source of a cash payment is not without its difficulties. See Levin, Adess & McGaffey, *supra*, note 4, at 290 n. 15.

between all stock and stock plus cash in the acquired corporation is not the significant factor. See *McDonald v. Commissioner, supra* at 89. As a general rule, we would apply the *Wright* test where only the latter offer was available. However, the source of the offer in whatever form may be a fact and circumstance to be taken into account in certain situations. See *supra* note 18.

Our analysis of the issue before us herein has convinced us that neither the *Shimberg* test nor the *Wright* test can be inexorably applied to "boot" distributions in connection with a reorganization, fully within which the ambit of section 356(a)(2). Each test has its supporting and criticizing arguments. See, e.g., Kyser, *supra* note 4; Rands, *supra* note 4; Levin, Adess & McGaffey, *supra* note 4; Comment, *supra* note 4. However, we think that, on balance, the *Wright* test is the more suitable vehicle for decision principally because its application produces a result more within the scope of the type of reorganization Congress had in mind in enacting section 356(a)(2), i.e., where there is an overlapping of ownership between the acquired and acquiring corporations, than the *Shimberg* test which would tend to produce exactly the opposite result. Moreover, unlike the *Wright* test, the *Shimberg* test would make the result dependent upon which corporation, the acquired or the acquiring, survived a merger. Indeed the deficiencies in the *Shimberg* test are sufficient to cause its supporters to suggest that the *Wright* test be applied where there is a "commonality" of ownership of the acquired and acquiring corporations and the *Shimberg* test be reserved for situations where such commonality does not exist. See, e.g., Kyser, *supra* note 4, at 331; Rands, *supra* note 4, at 116. We have difficulty in applying such a bifurcated approach to a statute which seems to make no distinction between different reorganizations. Cf. *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 230-231 (1970); Levin, Adess & McGaffey, *supra* note 4,

at 306. Furthermore, such an approach would add another difficult dimension to the application of section 356, i.e., determining how much overlap of stock ownership would constitute commonality. See Kyser, *supra* note 4, at 329-332.

One final word. The root of the problem of choice between the *Wright* test and the *Shimberg* test lies in the low level of "continuity of interest" required to constitute a type of tax-free reorganization. The result of this low-level requirement is to cause transactions to be treated as reorganizations which really should be considered sales, i.e., where there is a substantial amount of cash paid and/or the stock of the acquiring corporation can be readily disposed of by the taxpayer. See, e.g., Kyser *supra* note 4, at 315 n. 90 and 340. But this condition has existed far too long for the judiciary now to change the rules of the game. If a change is to come, it must come from the legislature. We think the same is true with respect to adopting a bright-line test, under section 356(a)(2), i.e., a rule applicable without qualification to all cases, to determine whether a distribution has "the effect * * * of a dividend." In the meantime, the courts, the Executive, and taxpayers will be forced to live with a test which admittedly is imprecise in that it will not be inexorably applicable in all situations.

To reflect the foregoing and petitioners' concessions on other issues,

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, GOFFE, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, and WILLIAMS, *JJ.*, agree with this opinion.

SIMPSON, WILBUR, CHABOT, GERBER, and PARR, *JJ.*, did not participate in the consideration of this case.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 86-1736

DONALD E. CLARK; PEGGY S. CLARK,
PLAINTIFFS-APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE,
DEFENDANT-APPELLANT

Appeal from the Tax Court of the United States

[Filed: September 4, 1987]

JUDGMENT

This cause came on to be heard on the trancript of the record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the decision of said The Tax Court of the United States, in this cause, be, and the same is hereby, affirmed.

/s/ JOHN M. GREACEN
John M. Greacen
Clerk

A True Copy, Teste:
John M. Greacen, Clerk
By: BARBARA RAVE
Deputy Clerk

APPENDIX D

The Internal Revenue Code (26 U.S.C.) provides in pertinent part:

Section 302. *Distributions in redemption of stock*

(a) *General rule*

If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part of full payment in exchange for the stock.

(b) *Redemptions treated as exchanges*

(1) *Redemptions not equivalent to dividends*

Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock*

(A) *In general*

Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation*

This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions*

For the purposes of this paragraph, the distribution is substantially disproportionate if –

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of –

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions*

This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disappropriate with respect to the shareholder.

(3) *Termination of shareholder's interest*

Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) *Redemption from noncorporate shareholder in partial liquidation*

Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

(5) *Application of paragraphs*

In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

Section 316. *Dividend defined*

(a) *General rule*

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Section 317. *Other definitions*

(a) *Property*

For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) *Redemption of stock*

For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

Section 354. *Exchanges of stock and securities in certain reorganizations.*

(a) *General rule*

(1) *In general*

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(3) *Cross reference*

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (2)(B) applies), see section 356.

Section 356. *Receipt of additional consideration*

(a) *gain on exchanges*

(1) *Recognition of Gain*

If–

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend*

If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE 1988 – 202 037/60216

87-1168

No. 87-1167

Supreme Court, U.S.
FILED
FEB 12 1988
JOSEPH F. SPANIOL, JR.
CLERK

In The

Supreme Court of the United States

October Term, 1987

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

DONALD E. CLARK AND PEGGY S. CLARK,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

*Walter B. Slocombe
Daniel B. Rosenbaum
Caplin & Drysdale, Chartered
One Thomas Circle, N.W.
Washington, D.C. 20005
(202) 862-5000

February 1988

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
or call collect (402) 342-2831

3188

QUESTION PRESENTED

When respondent's company was acquired, by a publicly held company, in a tax-free reorganization, respondent received 300,000 shares of common stock and chose to receive cash instead of 125,000 additional shares of the acquiring company's stock. The question presented is whether, under section 356(a)(2) of the Internal Revenue Code, the cash he received in lieu of additional stock should have been taxed as a capital gain or as a dividend.

TABLE OF CONTENTS

	Page
OPINIONS BELOW	1
JURISDICTION	2
STATEMENT	2
ARGUMENT	5
Summary	5
Discussion	6
1. *The decision below is clearly correct.*	6
a. *The court below correctly looked to Section 302 for guidance.*	7
b. *The court below properly treated the transaction as an integrated whole, considering the effect of receiving cash on the taxpayer's interest in the continuing business.*	11
c. *The Executive Branch has already agreed to accept legislation codifying the analysis of the court below.*	15
2. *There is no conflict requiring this Court's attention.*	16
3. *This Court should not attempt to resolve the issue presented here before it is resolved within petitioner's own ranks.*	22
CONCLUSION	25

TABLE OF AUTHORITIES

Page

CASES:

Commissioner of Internal Revenue v. Bedford's Estate, 325 U.S. 283 (1945) 10

General Housewares Corp. v. United States, 615 F.2d 1056 (5th Cir. 1980) 15

Hawkinson v. Commissioner of Internal Revenue, 235 F.2d 747 (2d Cir. 1956) 8, 10, 18

King Enterprises, Inc. v. United States, 189 Ct. Cl. 466, 418 F.2d 511 (1969) 8, 10, 17

Lewis v. Commissioner of Internal Revenue, 176 F.2d 646 (1st Cir. 1949) 11

Lorillard v. Pons, 434 U.S. 575 (1978) 9

Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938) ... 12

Ross v. United States, 146 Ct. Cl. 223, 173 F. Supp. 793, *cert. denied*, 361 U.S. 875 (1959) 8

Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979) ..... *passim*

United States v. Davis, 397 U.S. 301 (1970) 7, 11

Wright v. United States, 482 F.2d 600 (8th Cir. 1973) ..... *passim*

Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) 12

STATUTES:

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 302 ..... *passim*

Sec. 302(b)(1) 7, 8

Sec. 302(b)(2) 7, 12

Sec. 302(b)(3) 8

TABLE OF AUTHORITIES—Continued

Page

Sec. 318 9

Sec. 356 ..... 7, 8, 9

Sec. 356(a)(1) 4, 7

Sec. 356(a)(2) ..... *passim*

Sec. 368 6

Sec. 368(a)(1)(A) 3

Sec. 368(a)(2)(D) 3

RULES AND REGULATIONS:

Priv. Ltr. Rul. 8640064 (July 8, 1986) 21

Priv. Ltr. Rul. 8728037 (April 13, 1987) 10

Priv. Ltr. Rul. 8748038 (September 1, 1987) 10

Rev. Rul. 75-83, 1975-1 C.B. 112 ..... 10, 17, 18, 21, 22, 23

Rev. Rul. 76-385, 1976-2 C.B. 92 7

Treas. Reg. § 1.368-1(b) 11

Treas. Reg. § 1.6661-3 21

LEGISLATIVE MATERIALS:

Reform of Corporate Taxation: Hearing Before the Committee on Finance United States Senate, 98th Cong., 1st Sess. (1983) 16

H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess., at 845 (1984) 9

H.R. Conf. Rep. No. 100-495, 100th Cong., 1st Sess., Part III (1987) 20

TABLE OF AUTHORITIES—Continued

	Page
Staff of The Committee on Finance United States Senate, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations* (S. Prt. 98-95 1983)	14
Staff of The Committee on Finance United States Senate, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47 1985)	14, 16
Joint Committee on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals in Connection with Committee on Finance Markup* (JCS 8-86), March 18, 1986	14, 19
MISCELLANEOUS:	
ABA Legislative Recommendation 1983-8 (approved by ABA House of Delegates at 1984 Midyear Meeting)	14
Fleming, "Reforming the Tax Treatment of Reorganization Boot," 10 J. Corp. Tax 99 (1983)	14
Golub, " 'Boot' in Reorganizations—The Dividend Equivalency Test of Section 356(a)(2)," 58 Taxes 904 (1980)	14
Levin, Adess, & McGaffey, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 Tax Lawyer 287 (1977)	14
"Tax Court Decision Could Ruin Risk Arb Biz," Investment Dealers' Digest (February 17, 1986), p.2	20

No. 87-1167

—o—

In The

Supreme Court of the United States

October Term, 1987

—o—

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

DONALD E. CLARK AND PEGGY S. CLARK,

Respondents.

—o—

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

—o—

BRIEF FOR THE RESPONDENTS IN OPPOSITION

—o—

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. App. 1a-14a) is reported at 828 F.2d 221. The opinion of the Tax Court (Pet. App. 15a-39a) is reported at 86 T.C. 138.

—o—

JURISDICTION

The judgment of the Court of Appeals (Pet. App. 40a) was entered on September 4, 1987. The petition was (taking account of extensions of time) timely filed on January 11, 1988 and received by respondent on January 14, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Donald Clark, the respondent,[1] was the sole shareholder of Basin Surveys, Inc., a West Virginia corporation engaged in the business of providing technical services to the petroleum industry. In 1978, N.L. Industries (NL), a publicly held company listed on the New York Stock Exchange, initiated negotiations with Clark over the possible acquisition of Basin. In the final negotiating session, NL offered Clark two alternatives as the price NL was willing to pay for the stock of Basin: Clark had a choice of receiving (1) 425,000 shares of NL common stock, or (2) 300,000 shares of NL common stock and, instead of the additional 125,000 shares, $3.25 million in cash. After considering the alternative proposals, Clark decided to accept the offer which provided him with cash

[1] Mr. Clark's wife, Peggy S. Clark, is a party solely because she filed a joint return with her husband for the year in question.

in lieu of the additional shares of stock.[2] In April 1979, the acquisition was consummated on that basis.[3]

As a result of Clark's acceptance of the combined stock and cash offer, the total number of NL common shares outstanding increased to approximately 32,833,000 shares, and Clark's stockholdings represented approximately 0.92 percent of that total. If Clark had accepted the all-stock offer of 425,000 shares, the total number of NL common shares outstanding would have increased to approximately 32,958,000 shares, and Clark's stockholdings would have represented approximately 1.3 percent of that total. (Pet. App. 16a.) Clark's 300,000 share ownership of NL after the transaction was 70.6 percent of the 425,000 shares he would have owned had he taken the all-stock offer.

The transaction qualified as a "reorganization" under Section 368(a)(1)(A) and (a)(2)(D) of the Internal

[2] In the Tax Court, Clark's attorney testified (and it was agreed that, if called, Clark would testify to the same effect) that Clark originally sought NL stock as the sole consideration for his Basin stock (C.A. App. 49-50). Also at trial, the official who represented NL in the negotiations testified that NL was prepared to go forward with the transaction on the basis of either alternative; that it did not know which offer Clark would accept; that its preference was to pay Clark a portion of the consideration in cash as a means of reducing the number of shares of NL stock that would be outstanding after the acquisition; and that the amount of cash offered to Clark was based on NL's determination of the value of the additional 125,000 shares that it would have had to issue to Clark in the all-stock proposal. (C.A. App. 36-37).

[3] The acquisition was structured as a merger of Basin into a wholly owned subsidiary of NL.

Revenue Code of 1954.[4] (Pet. App. 16a-17a.) Under Section 356(a)(1), Clark was required to pay tax on the $3.25 million cash or "boot" payment to the extent of his gain on the transaction with NL. Since Clark's gain (after taking into account the cash and market value of the NL stock received by Clark in exchange for his Basin stock) exceeded the amount of cash received, Clark reported the entire cash payment as gain, taxable at long term capital gain rates under Section 356(a)(2).[5] On audit, the IRS determined that the cash received by Clark had "the effect of a distribution of a dividend" under Section 356(a)(2) and was, therefore, taxable as a dividend.[6] Because, in 1979, dividends were taxable at ordinary income rates, while capital gains were taxed at only 40 percent of ordinary rates, this determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979.

Clark petitioned the Tax Court for review of the IRS determination. A trial was held in the Tax Court at which Clark, the NL official who represented NL in the acquisition, and Clark's attorney provided testimony on the negotiations between the parties. The Tax Court, in a reviewed decision with no dissents among the fifteen participating judges, held in favor of the respondent. (Pet.

---

[4] All statutory references are to the Internal Revenue Code of 1954, as in effect for the year 1979, unless otherwise specified.

[5] Because of a computational error, the amount of gain actually reported on the return was $3,195,294. In his later computation for entry of decision by the Tax Court, Clark stipulated that the amount of gain recognized and reported should have been $3,250,000.

[6] Pursuant to sec. 356(a)(2), the amount claimed to be taxable as a dividend was $2,319,611, the accumulated earnings and profits of Basin on the acquisition date.

App. 15a-39a.) The Fourth Circuit affirmed, with no dissents. (Pet. App. 1a-14a.)

The Fourth Circuit and the Tax Court considered the two circuit court cases which had previously addressed the issue presented here—*Wright v. United States*, 482 F.2d 600 (8th Cir. 1973) and *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979). Both courts agreed with the approach adopted by the Eighth Circuit in *Wright*, which produced capital gain treatment, and both rejected *Shimberg*, which would have yielded dividend treatment, as a case in which the Fifth Circuit had reached the contrary result because it (and the district court whose decision it reversed) had misunderstood the court's holding in *Wright*. (Pet. App. 13a, 27a-29a.)

———o———

ARGUMENT

Summary

The decisions of the Court of Appeals and the Tax Court are correct. They are in accord with basic tax principles applicable in the dividend equivalency and reorganization areas, the decisions of this Court and other federal courts, the views of numerous tax commentators and the American Bar Association, and the legislative recommendations of the staff of the Senate Finance Committee. Indeed, the Treasury Department has agreed to a proposed legislative amendment that would codify the approach adopted below; and the Commissioner himself, has a long-standing, published position which is at odds with the

position advanced on his behalf in the Court of Appeals and in the petition.

Petitioner overstates the administrative importance of the alleged conflict between this case (and *Wright*) on the one hand and *Shimberg* on the other. Because of the elimination of favorable capital gains rates, in the case of individual shareholders no practical consequence normally attaches any longer as to whether boot is treated as a dividend or as capital gain. It is true that corporate shareholders generally pay lower taxes if, contrary to the opinion below and in *Wright*, boot is treated as a dividend (because of the 80 or 70 percent dividends received deduction). However, if, as suggested in the petition, the Commissioner were to adopt the approach of the courts below, it is unlikely that such corporate taxpayers would rely on the opinion in *Shimberg*, which is widely regarded as a "sport," to classify boot such as existed here as dividends. In any event, it is premature for petitioner to ask this Court to resolve the alleged conflict, when no such effort to use *Shimberg* to reduce future revenues has arisen and when the issue presented apparently has not been resolved within the Government's own ranks.

Discussion

1. *The decision below is clearly correct.* The law at issue here is easily summarized: In a corporate acquisition which qualifies as a "tax-free" reorganization under Section 368, if a shareholder of the acquired corporation receives (in addition to stock in the acquiring company) cash or other property ("boot"), he or she must recognize gain on the transaction up to the amount of the boot received (Section 356(a)(1)). That gain is a capital gain unless the receipt of boot "has the effect of the distribution of a dividend," in which case the shareholder must treat it as a dividend (taxed at higher rates in the year at issue) up to his or her ratable share of accumulated earnings and profits of the corporation. Section 356(a)(2). The sole issue here is, therefore, whether the cash payment to Mr. Clark had "the effect of a dividend" within the meaning of Section 356, so that, under the rate structure then in effect, it should have been taxed as ordinary income rather than as the capital gain he reported.

a. *The court below correctly looked to Section 302 for guidance.* The initial question considered below is the source of guidance by which to identify a dividend. Section 356 does not contain any guidelines by which to discern the "effect of a dividend." However, Section 302 contains general principles for determining when a distribution of cash by a continuing corporation is equivalent to a dividend and when it results in the distributee shareholder's parting with a sufficiently large interest in the corporation to qualify for sale or exchange treatment.[7] Virtually all

---

[7] Under Section 302, the distribution qualifies for capital gain treatment if it satisfies one of the following three tests:

(1) The distribution is "not essentially equivalent to a dividend." Section 302(b)(1). This has been interpreted to mean that the distribution effects a "meaningful reduction" in the shareholder's percentage interest. *United States* v. *Davis*, 397 U.S. 301, 313 (1970). In the case of a minority shareholder, virtually any reduction in his percentage interest is considered "meaningful." *See, e.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92 (reduction from 0.0001118 percent to 0.0001081 percent).

(2) The distribution effects a "substantially disproportionate" redemption of stock. Under Section 302(b)(2), this means

(Continued on following page)

of the courts which have considered the question, including the courts below, have held that the principles of Section 302 should be applied in determining dividend equivalency under Section 356(a)(2). *See, Wright v. United States, supra,* at 605; *King Enterprises, Inc. v. United States,* 418 F.2d 511, 520-21 (Ct. Cl. 1969); *Ross v. United States,* 146 Ct. Cl. 223, 173 F. Supp. 793, 797, *cert. denied,* 361 U.S. 875 (1959); *Hawkinson v. Commissioner,* 235 F.2d 747, 751 (2d Cir. 1956). *See also Shimberg v. United States, supra,* at 287 n. 13 (stating that Section 302 applies in "appropriate cases").

As noted by the Fourth Circuit, "there are several persuasive reasons why § 302 should be used in determining whether boot should be taxed as ordinary income." (Pet. App. 5a.) Most importantly, Section 302 and Section 356 address the same issue—whether a particular corporate distribution should be treated as a dividend or as a sale or exchange of a portion of the shareholder's interest in the corporation. The two sections also contain similar language.[8] Finally, this interrelationship between the two sections has been expressly recognized by Congress. In

---

(Continued from previous page)

that immediately after the distribution, the percentage interest of the distributee shareholder in the voting stock of the corporation must be (i) less than 50 percent, and (ii) less than 80 percent of what it was immediately prior to the distribution.

(3) The distribution effects a complete termination of the distributee shareholder's equity interest in the corporation. Section 302(b)(3).

[8] Section 302(b)(1) provides for ordinary income treatment if the distribution is "essentially equivalent to a dividend," while Section 356(a)(2) treats boot as ordinary income if it "has the effect of a distribution of a dividend."

the Conference Committee Report for the Deficit Reduction Act of 1984, which made changes in the reorganization provisions, it is stated unequivocally that "[t]he principles of section 302 are applicable in testing for dividend equivalency under section 356." H.R. Conf. Rep. No. 98-861, 98th Cong. 2d Sess. 1, 845 (1984-3 C.B. (Vol. 2) 1, 99).[9]

On appeal to the Fourth Circuit, the Commissioner challenged this proposition and argued that the principles of Section 302 are not applicable in the reorganization context, and that, under special standards to be developed for Section 356(a)(2) only (presumably on a case-by-case basis), a distribution such as the one here should be treated

---

[9] This Court has recognized that such express Congressional recognition of the judical and administrative interpretation of a statute should be given great weight in determining the meaning of the relevant provisions. *Cf. Lorillard v. Pons,* 434 U.S. 575, 580 (1978). Apart from the statement in the Conference Committee Report, the 1984 amendment, itself, requires the conclusion that the principles of Section 302 apply in determining dividend equivalency under Section 356(a)(2). The amendment adds language to Section 356(a)(2) to make it clear that the question of whether a distribution has the effect of a dividend is to be "determined with the application of [the attribution rules of] section 318(a)." This amendment would have little, if any, meaning unless it were assumed that the tests for determining dividend equivalency contained in Section 302 are applicable. Thus, the tests contained in Section 302 require a determination of the shareholder's percentage interest in the corporation before and after the distribution. For purposes of this determination, stock owned by individuals and entities which are related to the shareholder, within the meaning of Section 318, are deemed to be owned directly by the shareholder. Unless the Section 302 test of a change in ownership interest were to be applied for Section 356(a)(2) purposes, there would be no need for an attribution rule to compute such ownership interests.

as a dividend.[10] The Fourth Circuit was troubled by the Commissioner's new approach: "[I]n return for abandoning the § 302 analysis, the Commissioner offers no realistic alternative, except perhaps a return to the abandoned rule that any pro rata distribution in a reorganization must automatically be treated as a dividend."[11] (Pet. App. 6a.) The Fourth Circuit squarely rejected the petitioner's general argument and instead "join[ed] the long line of courts that have applied § 302 in the reorganization context." (Pet. App. 6a.) Petitioner does not, in this Court, mount a general attack on the use of Section 302, only on its application, but once Section 302 is applied, the holding below necessarily follows.

---

[10] It should be noted that, although petitioner's litigating position before this Court is now one of agnosticism as to whether Section 302 applies, the official position of the Internal Revenue Service is that the principles of Section 302 do indeed apply in determining dividend equivalency under Section 356 (a)(2). *See*, Rev. Rul. 75-83, 1975-1 C.B. 112; Priv. Ltr. Rul. 8728037 (April 13, 1987); Priv. Ltr. Rul. 8748038 (September 1, 1987).

[11] As a result of *dicta* in *Commissioner* v. *Bedford's Estate*, 325 U.S. 283, 292 (1945), for many years it was assumed that cash or property other than qualifying stock or securities received in a corporate reorganization would always have the effect of a taxable dividend to the extent of the corporation's accumulated earnings and profits. This "automatic dividend" rule came under increasing criticism, however, as being "difficult to reconcile" with the language of Section 356(a)(2), which implies that certain distributions might have the effect of a dividend while others might not. *See e.g., Hawkinson v. Commissioner*, 235 F.2d 747, 750-51 (2d Cir. 1956). As a result, the courts and the Internal Revenue Service have now retreated from the automatic dividend rule. *See e.g., Wright v. United States, supra*, at 605; *Shimberg v. United States, supra*, at 287; *King Enterprises, Inc. v. United States*, 418 F.2d 511, 520 (Ct.Cl. 1969).

b. *The court below properly treated the transaction as an integrated whole, considering the effect of receiving cash on the taxpayer's interest in the continuing business.* This Court has established that the basic characteristic of a dividend is a distribution to shareholders "without a change in the relative economic interests or rights of the shareholders." *United States v Davis*, 397 U.S. 301, 313 (1970). Section 302, in accord with that principle, measures whether exchange, rather than dividend, treatment is appropriate by considering whether the shareholder has experienced a significant reduction in his ownership interest as a result of the cash payment, so that the transaction is treated as a sale or exchange, of a portion of that ownership interest for cash. In a tax-free reorganization, such as occurred here, measuring the effect of the cash requires measuring the effect of the distribution on the taxpayer's interest in the combined corporation that emerged from the transaction—here NL. This follows because the "essence of [a tax-free reorganization] is a continuance of the proprietary interests in the continuing enterprise under modified corporate form." *Lewis v. Commissioner*, 176 F.2d 646, 648 (1st Cir. 1949); *see also*, Treas. Reg. § 1.368-1(b).

Consistent with these principles, the courts below held that the relevant inquiry was to compare the economic interest that Clark had in the continuing enterprise, NL, as a result of receiving the boot distribution with what that interest would have been had no boot been received.[12]

---

[12] (Pet. App. 14a, 34a-35a.) It is a measure of the degree to which the result below turns on the particular facts of this case that the Fourth Circuit, like the Tax Court, stressed that, on

(Continued on following page)

Specifically, applying Section 302, the Fourth Circuit concluded that the transaction should be examined as an integrated whole, in which "the tax consequences . . . should reflect the reality of Clark's choice to forego 125,000 shares of N.L. stock," not, as petitioner argues, as if the receipt of the cash were a transaction entirely separate from the simultaneous and related transfer of the company to NL. The Fourth Circuit found, "by taking the cash, Clark surrendered his potential interest in N.L. to the extent of almost 30%." Accordingly, he was entitled, under Section 302, to treat the income as capital gain.[13]

The integrated approach adopted by the courts below is also in accord with the established principle of tax law known as the "step transaction" doctrine. Under this doctrine, rather than giving separate consideration to each of the various steps which comprise an integrated transaction, the steps are viewed together in light of the overall transaction to determine their tax effect. *See e.g. Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938); *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954). The courts below approached the facts of this case from an "integrated perspective." (Pet. App. 13a.) They focused on

---

(Continued from previous page)

this record, there was direct and unchallenged evidence of what the taxpayer's interests in NL would have been had he not received the boot, because he was offered a direct choice of the cash or 125,000 more shares of NL stock.

[13] Here, as the Tax Court pointed out, because Clark experienced more than a 20 percent reduction in his potential ownership interest in NL, the transaction qualified for sale or exchange treatment under the "safe harbor" of Section 302(b)(2). (Pet. App. 34a-35a.)

the overall transaction and, in accordance with both historical fact and economic reality, treated the cash boot as a payment in consideration for Clark's acceptance of a lesser interest in the continuing enterprise which emerged from the reorganization.

In contrast, the Commissioner's approach—and that of *Shimberg*—is to ignore the overall effect of the transaction and treat the cash payment in isolation, as having been made "pro rata" to Clark as a stockholder of Basin, while that company was still in existence and Clark was still its sole shareholder.[14] The Commissioner, following *Shimberg*, would measure the effect of the distribution as though it had occurred as an independent transaction, and he would ignore its effect on Clark's ownership interest in NL, the continuing enterprise in the reorganization.[15]

---

[14] Petitioner assiduously tries to avoid acknowledging that his position is one which requires a fragmented view of the distribution. However, as the Fourth Circuit observed (Pet. App. 7a-8a), the Government's "pro rata" approach is necessarily based on the view that Clark received the $3,250,000 from Basin before that company was merged into NL. For the distribution in issue here can be viewed as pro rata only if it is viewed as having been made to Clark while Basin was still in existence and he was still its sole shareholder. In contrast, the distribution clearly would not be pro rata if it were viewed as having been made by NL to Clark simultaneously with his becoming a stockholder of NL in exchange for shares in that company, since only he and not the other shareholders of NL received cash.

[15] Again, the facts of this case underlie the analysis of the courts below and highlight the unrealism of the Commissioner's position. Thus, as the Tax Court pointed out, the facts make it especially difficult to view this case as involving a pre-reorganization distribution by Clark's company, since that company had nowhere near enough money to have paid the cash

(Continued on following page)

The more realistic, integrated method of analysis used by the courts below had previously been adopted by the Eighth Circuit in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973). It has been endorsed by numerous commentators and by the American Bar Association,[16] and recommended for statutory codification by the Staff and the Chairman of the Senate Finance Committee.[17] *Shimberg*—with its contrary, artificial analysis of the receipt of the cash boot as unrelated to the simultaneous receipt of stock—is regarded as an aberration, resulting from a

---

(Continued from previous page)

itself. Accordingly, here there was no issue of a pre-reorganization distribution of a cash accumulation. Pet. App. 37a. Indeed, the amount of cash received by Clark was much greater than the amount of Basin's liquid assets or the book value of its net equity—illustrating the contrived nature of the Government's notional "dividend" of the cash by Basin just before an unrelated stock-for-stock exchange with NL. In short, contrary to the Government's assertion, there is no economic basis for treating the cash received from NL as a bail-out of Basin's earnings, rather than a payment by NL in lieu of additional NL stock.

[16] *See* ABA Legislative Recommendation 1983-8 (approved by ABA House of Delegates at 1984 Midyear Meeting); Levin, Adess, & McGaffey, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 Tax Lawyer 287, 288 (1977); Golub, "'Boot' in Reorganizations—The Dividend Equivalency Test of Section 356(a)(2)," 58 Taxes 904, 911-13 (1980); Fleming, "Reforming the Tax Treatment of Reorganization Boot," 10 J. Corp. Tax 99, 107-110 (1983).

[17] *See* Staff of The Committee on Finance United States Senate, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations*, 63 (S. Prt. 98-95, 1983); Staff of The Committee on Finance United States Senate, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 6, 217-18 (S. Prt. 99-47, 1985); Joint Committee on Taxation, 99th Cong., 2d Sess. *Tax Reform Proposals in Connection with Committee on Finance Markup* (JCS 8-86), March 18, 1986.

misreading—both by the Fifth Circuit and by the district court it reversed—of the *Wright* approach adopted by the courts below in this case.[18]

c. *The Executive Branch has already agreed to accept legislation codifying the analysis of the court below.* In fact, the executive branch has already decided that the approach taken by the courts below and challenged by petitioner here is acceptable as a matter of tax policy. A major study of revision of "Subchapter C" of the Internal Revenue Code, that is, of the provisions dealing with taxation of corporate distributions and reorganizations, has been underway for the past several years. One of the issues considered has been the proper treatment of transactions such as Clark's sale of his business. Consistent with the recommendations of the American Bar Association's special committee on the question, the staff of the Senate Finance Committee recommended in 1983 that the *Wright* analysis, adopted by the courts below in this case, should be expressly codified in the statute and the *Shimberg* approach rejected.[19]

---

[18] Specifically, it seems clear that the *Shimberg* court understood the taxpayer there to be arguing that under *Wright*, the relevant comparison was between his dominant ownership percentage in the acquired company and his small minority ownership in the post-acquisition company, not between what his ownership in that continuing company would have been with and without the boot. *See* Pet. App. 13a, 28a. *See also General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980) where, as the Tax Court pointed out, "[t]he Fifth Circuit's misunderstanding of the *Wright* holding is even more clearly evidenced. Pet. App. 28a, n. 8.

[19] *See* nn. 16 and 17.

In 1983, the Treasury Department, through the Office of the Assistant Secretary for Tax Policy, the agency charged with developing tax policy for the executive branch, presented its formal position on the recommendation. Viewing *Wright* and *Shimberg* as offering alternative tax approaches to the same question, and reviewing the arguments on both sides, the Treasury statement described the matter as "a very close call," and concluded that "on balance, we do not object to the Staff's recommended approach," which it described as measuring whether boot has the "effect of a dividend" by look[ing] to the shareholders' reduction in interest as measured *after* the acquisition."[20] That approach is exactly the analysis employed by the court below in this case.

The effect of this statement of the Treasury Department's position is that, in urging this Court to hear this case and decide it on the basis of *Shimberg*, petitioner is in the anomalous position of asking this Court for the opportunity to persuade it of a position the tax policy authorities have already decided is "on balance" incorrect.

On all counts, therefore, the approach adopted by the court below is, and is widely regarded as, sound and correct. Indeed, it has been accepted by the tax policy authorities of the executive branch.

2. *There is no conflict requiring this Court's attention.* Petitioner also claims that, apart from alleged de-

---

[20] *See Reform of Corporate Taxation: Hearing Before the Committee On Finance United States Senate*, 98th Cong., 1st Sess., 24-25 (S. Hrg. 98-556, 1983) (emphasis in original); *see also* Staff of The Committee on Finance United States Senate, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 6 (S. Prt. 99-47, 1985).

fects on the merits, the conflict of the decision below with the 1979 Fifth Circuit decision in *Shimberg* will create significant problems for the administration of the tax laws unless this Court grants review. There are significant differences between the facts of this case and those of *Shimberg*,[21] but in any event, the petitioner greatly overstates the problems that would arise were this Court to decline to resolve the conflict now.[22]

---

[21] In the present case, the taxpayer was actually offered a choice between an all-stock deal and a deal with less stock and cash; no such clear alternative was available to the seller in *Shimberg*. Also, here, as contrasted to *Shimberg*, the acquired corporation did not have sufficient accumulated earnings and profits, or net assets, much less cash, to cover the amount of cash paid to the seller in the reorganization.

Although petitioner finds a "clear conflict" to be present here, it should be noted that, in 1978, the Government opposed the taxpayer's petition for certiorari in *Shimberg* on the tenuous factual ground that the holding of that case did not conflict with the holding in *Wright*, because in the latter case the acquired and acquiring corporations were controlled by the same interests. There is not the slightest suggestion in the *Wright* opinion that the approach adopted there, and the underlying rationale for that approach, were based on the fact that the acquired and acquiring corporations were related entities. Moreover, apart from the Government in its Brief in Opposition in *Shimberg*, everyone else who has considered the *Wright* case (including the courts, Congress, commentators and even the Internal Revenue Service—see Rev. Rul. 75-83, 1975-1 C.B. 112—and the Treasury Department in its comment on Subchapter C revision) has interpreted *Wright's* holding to be applicable in cases involving unrelated corporations and therefore in conflict with *Shimberg*.

[22] Whatever the merits of petitioner's contention that the decision below conflicts with *Shimberg*, there is no merit to his contention (Pet. 8) that the decision below conflicts with other circuit court cases. As the Tax Court pointed out, in *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct.Cl. 1969), there was no dispute that the dividend determination should be made with

(Continued on following page)

Most important, insofar as the decision below aids taxpayers who want to treat income as capital gain rather than dividends, the issues treated in this case, in *Wright* and in *Shimberg*, are of no continuing importance. The practical impact of the characterization of "boot" as capital gain rather than ordinary income has been almost entirely eliminated by the abolition, in the 1986 Tax Reform Act, of the lower tax rate for capital gain income of both individuals and corporations.[23] Petitioner argues (Pet. at 9 n.6) that the elimination of the differential rates may be "something of an experiment." The possibility that Congress might at some future point reverse a basic tax policy decision of the 1986 Act is far too speculative to justify this Court reviewing a decision on the basis of the significance it would have only if that reversal occurred.

Moreover, as noted above, the executive branch tax policy authorities have already agreed to accept a codification of the result in this case as a part of a pending broad revision of the taxation of corporate reorganiza-

---

(Continued from previous page)

references to the acquired corporation," while in *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956), the appeals court "clearly did not confront the issue of choice between the acquired and the acquiring corporation." (Pet. App. 24a, n. 7.)

[23] Petitioner's claim (Pet. at 10-11) that acceptance of the decisions below and in *Wright* would require other adjustments, *e.g.*, to the amount of gain, basis in the acquired stock, and earnings and profits is simply incorrect. As the Fourth Circuit pointed out, the issue of the *character* of the boot income—governed by Section 356(a)(2) and (even according to the IRS in Rev. Rul. 75-83) Section 302—is entirely separate from the issue of the *amount* of such gain and the effect of the transaction on earnings and profits. These latter issues are provided for in detail in Section 356(a). (*See* Pet. App. 6a.)

tions. General revision of Subchapter C, including codifying the method of analysis that led to the decision below, remains on the Congressional agenda.[24] If it is appropriate to consider the prospect of future action by Congress in deciding whether this Court should hear tax cases, it is far more reasonable to assume that Congress will in the near future enact the pending general Subchapter C revisions, which are relatively non-controversial, than that it will restore the capital gain/ordinary income differential, which would be a major policy change.

Petitioner also suggests that, even without a capital gain/ordinary income differential, there will be serious tax administration problems if this Court does not inform the tax world whether *Shimberg* on the one hand, or the decisions below and in *Wright*, on the other, correctly states the law. Specifically, petitioner suggests that, while most taxpayers are now largely indifferent to the character of boot income, some corporate taxpayers actually prefer the result in *Shimberg*, because an expansive scope for dividend treatment will make boot income subject to the corporate "dividends-received" deduction.[25]

---

[24] Indeed, provisions to effect such a revision, including codifying the analysis used below as previously accepted by Treasury, was included at one point in the 1986 Act, and dropped only because of the desire not to attempt to effect this complex but essentially technical change amid the controversy over the 1986 Act. *See* Joint Committee on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals in Connection with Senate Finance Committee Markup*, (JCS 8-86), March 18, 1986.

[25] As a result of an amendment to Section 243 included in the Budget Reconciliation Act of 1987, the dividends-received deduction is currently equal to 80 percent of the amount of

(Continued on following page)

Petitioner's specter of corporate taxpayers relying on *Shimberg* to deny the Government revenues by improperly expanded dividends-received deductions is overdrawn and implausible. *Shimberg's* analysis has been heavily criticized by commentators, and it is viewed by the tax bar generally as an aberrational decision, occasioned by misinterpretation of the approach adopted in *Wright* and followed in this case. *Shimberg's* rejection by the courts below would be a further deterrent to corporate tax managers relying on its authority.[26]

In any event, if the Internal Revenue Service wishes to protect the revenues from unjustified reliance on *Shim-*

(Continued from previous page)

the dividend in the case of corporate shareholders owning 20 percent or more of the outstanding stock of the distributing corporation, and 70 percent of the amount of the dividend in the case of all other corporate shareholders. *See* H.R. Conf. Rep. No. 100-495, 100th Cong., 1st Sess., Part III at 425 (1987).

[26] The decision below has already been described as likely to reduce the possibility for abusive reliance on *Shimberg* by Wall Street arbitragers seeking to use dividends-received deductions in the context of acquisitive reorganizations. Such arbitragers purchase stock in a corporation before an acquisition transaction is closed and realize profits on the spread between the market price and the takeover price. If the acquisition is structured as a tax-free reorganization including some cash distribution to shareholders of the acquired corporation, corporate arbitragers could, embracing *Shimberg* and the petitioner's position in this Court, treat the boot (up to the amount of their gain on the arbitraging transaction) as a dividend, taxed at a much lower effective rate (after giving effect to the dividends received deduction) than if the boot were treated as capital gain on the transaction. According to a tax partner at one of the national accounting firms, "This [Clark] decision could eliminate many arbs from the takeover game" in which they have sought to reclassify cash payment of boot as dividends. *See* "Tax Court Decision Could Ruin Risk Arb Biz," Investment Dealers' Digest (February 17, 1986), p. 2. (A copy of this article is attached to respondent's appellate brief as Appendix 2).

berg, it has many resources of its own to bring to bear before it can justifiably ask this Court to intervene.[27] Petitioner routinely publishes revenue rulings or "acquiescences" declaring that it will henceforth follow certain cases.[28] To the degree that petitioner's concern is being whipsawed, he could greatly relieve that concern by publishing an announcement that *Wright* and the decision below and not *Shimberg* are to be followed in characterizing boot, for purposes of the dividends-received deduction as well as otherwise.

In the face of such action by petitioner—and the general weakness of *Shimberg* as a precedent—it would be a hardy corporate taxpayer indeed that would rely on *Shimberg* to expand its dividends-received deduction.[29] Those who did so would face a formidable hurdle in gaining judicial acceptance of their position, even in the Fifth

---

[27] If, for some reason, petitioner *wants* corporate taxpayers to remain able to reduce their taxes by taking advantage of *Shimberg*, he need do nothing at all.

[28] Having issued such an announcement, petitioner would, of course, abide by it in ruling on reorganizations, thereby dealing with the need for "the IRS to have a uniform rule to apply in issuing these rulings." (Pet. at 11). In fact, petitioner has followed this very procedure in communicating to taxpayers his position disagreeing with the opinion in *Wright* and subsequently applying that position to taxpayers requesting rulings on reorganization transactions. *See* Rev. Rul. 75-83, 1975-1 C.B. 112; e.g., Priv. Ltr. Rul. 8640064 (July 9, 1986).

[29] Indeed, in the face of a disavowal by the Commissioner of *Shimberg*, together with the widely held view (expressed by the courts below, as well) that *Shimberg* was wrongly decided, it is not even clear that *Shimberg* would constitute "substantial authority" sufficient to avoid a penalty under section 6661 for substantial understatement of taxable income, at least in the case of taxpayers residing outside of the Fifth and Twelfth circuits. *See* Treas. Reg. § 1.6661-3.

and Twelfth Circuits in which *Shimberg* is nominally authority. The chance that the petitioner would be unable to persuade those circuits to reconsider *Shimberg* seems small, but for present purposes it is sufficient to observe only if such an effort failed would review by this Court be appropriate.

3. *This Court should not attempt to resolve the issue presented here before it is resolved within petitioner's own ranks.* Petitioner has changed his position several times in this case on the proper analysis of the transaction at issue and still fails to present a position consistent either with his rulings in related areas or with the view of the tax policy authorities. In the Fourth Circuit, petitioner maintained that Section 302 principles do not apply at all in the case of a cash payment governed by Section 356(a)(2). This was contrary to petitioner's position in the Tax Court, in *Wright*, in Rev. Rul. 75-83, 1975-1 C.B. 112 (which is not mentioned in the petition, even though it is viewed by the IRS as the principal administrative pronouncement in this area) and in numerous private rulings (dealing with pro rata and non-pro-rata distributions in a reorganization) issued by the IRS, which conceded that Section 302 applied.

Petitioner's current attack on the Fourth Circuit decision before this Court, as outlined in the petition's extensive discussion of the merits, differs significantly from its fundamental argument to that court. There petitioner argued that the general "dividend equivalence" test of Section 302—under which the standard for being a dividend is whether the boot had the effect of substantially or "meaningfully" reducing Clark's equity interest—should not be applied at all in the reorganization context, where Section 356(a)(2) requires a determination of whether boot "has the effect of the distribution of a dividend." The Fourth Circuit clearly regarded that general attack on the applicability of Section 302 as the core of the Government's case and squarely rejected it. (Pet. App. 5a-6a.)

Now, having seen that position rejected when presented to the Fourth Circuit as the general issue posed by this case, petitioner takes a different and far less generalizable tack. Petitioner now declares only that "in the context presented here, there is no tension between the principles of Section 302 and the principles that should be applied under Section 356(a)(2)." (Pet. at. 19.) This shift in position, however, reduces the issue to whether the courts below—each of which explicitly applied the Section 302 rules to the Section 356(a)(2) problem—erred in applying the Section 302 rules to these particular facts, not whether they applied a correct standard.

Moreover, the tax policy authorities have already pronounced acceptable a codification of the analysis used below. Adoption by this Court of the position advanced by petitioner at this stage of the proceedings would only serve to confuse, rather than clarify, the state of the law in the corporate reorganization area. Even as reformulated, it is at odds with the approach of the Commissioner in Rev. Rul. 75-83 and in numerous private rulings. It

would be open to abuse and manipulation[30] and would, properly, be rejected by the IRS in many other situations as inconsistent with step transaction principles. And, as pointed out by the Fourth Circuit, in place of abandoning the principles of Section 302, it "offers no realistic alternative, except perhaps a return to the abandoned rule that any pro rata distribution in a reorganization must automatically be treated as a dividend." (Pet. App. 6a.)

Before this Court considers the issue presented here, petitioner should reconcile the differences within the executive branch.

* * *

In sum, petitioner is asking this Court to review the decision below to overturn a generally supported approach that the executive branch has already accepted in the legislative arena in favor of a position which has changed at each stage of this litigation. Moreover, it is doing so in a context of minimal continuing importance and where the petitioner himself should be able to eliminate any adverse effects on revenues from the conflict it perceives.

———o———

[30] For an example of how the Government's approach might be manipulated, see the opinion below. (Pet. App. 12a.)

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

*Walter B. Slocombe
Daniel B. Rosenbaum
Caplin & Drysdale, Chartered
One Thomas Circle, N.W.
Washington, D.C. 20005
(202) 862-5000

February 1988

*Counsel of Record

Supreme Court, U.S.
FILED
MAR 1 198
JOSEPH F. SPANIOL
CLERK

No. 87-1168

In the Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Page

Cases:

Shimberg v. *United States*, 557 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) 1, 3, 4, 6, 7, 8

Tribune Publishing Co. v. *United States*, No. 86-3734 (Jan. 6, 1988) 5

Statutes:

Internal Revenue Code (26 U.S.C.):

§ 302 7
§ 354 5
§ 356 ..... 4, 5
§ 356(a) 2
§ 356(a)(2) 3, 5, 7

Miscellaneous:

Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 Tax L. Rev. 297 (1984) 3, 4, 6

Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance, 98th Cong., 1st Sess. (1983) 6

Staff of the Senate Comm. on Finance, 98th Cong., 1st Sess., *S. Prt. 98-95, The Reform and Simplification of the Income Taxation of Corporations* (Comm. Print 1983) 6

In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-1168

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

In our petition, we explained that certiorari is appropriate here for the following reasons: (1) the decision below, which is incorrect (see Pet. 12-22), establishes a direct conflict with a line of previous court of appeals decisions, including *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979), on a recurring issue on which there are frequently large sums of money at stake (see Pet. 6-8, 14-16); (2) because the decision below is more advantageous to individual shareholders and the decision in *Shimberg* is more advantageous to corporate shareholders, the Internal Revenue Service (IRS) cannot avoid continued litigation on this issue by adopting either alternative (see Pet. 8-9); and (3) although this issue loses its significance to many individual shareholders in the absence of the rate differential between capital gain and ordinary income that was removed by the Tax Reform Act of 1986, the issue still has considerable administrative importance to the IRS because (a) it still will affect some individual shareholders, (b) it has lost

none of its significance to corporate shareholders, and (c) it may have collateral consequences on other important tax accounts such as basis and earnings and profits (see Pet. 9-11).Taken together, all of these factors will create substantial administrative problems for the IRS unless the conflict in the circuits is resolved.

Respondents do not seriously dispute the basic premises of our petition. While they note that there are "differences between the facts of this case and those of *Shimberg*" (Br. in Opp. 17 (footnote omitted)), they do not deny that the two decisions are in irreconcilable conflict. They acknowledge that the interests of corporate shareholders and individual shareholders are at odds on this issue and therefore that the IRS cannot satisfy both classes of taxpayers no matter what position it takes on the issue presented here. And they do not dispute that the elimination of the rate differential between capital gain and ordinary income does not affect the interests of corporate shareholders or of some individual shareholders who have capital losses on other transactions.[1] Respondents do contend, however, that for other reasons it is unnecessary for this Court to resolve the conflict in the circuits. This contention lacks merit.

---

[1] Respondents do dispute (Br. in Opp. 18 n.23) our contention that the conflict in the circuits injects considerable uncertainty into the treatment of other important tax accounts, such as basis and earnings and profits. Respondents assert that it is clear that the courts should accept respondents' proffered hypothetical redemption scenario only for the limited purpose of justifying capital gain treatment, but then should ignore that scenario when determining the other tax consequences of the transaction that might work to respondents' disadvantage. This assertion is, at best, highly questionable. At a minimum, it is manifest that the terms of Section 356(a) do not, as respondents suggest, resolve the uncertainties of computing basis, gain, and earnings and profits, that are created by respondents' hypothetical redemption scenario.

1. Respondents suggest (Br. in Opp. 20-22) that the IRS should solve its administrative problems by embracing the decision below. To justify this recommendation that the IRS repudiate its longstanding position, respondents advance the unsupported assertions that *Shimberg* is "widely regarded as a 'sport' " (Br. in Opp. 6) and that "it is viewed by the tax bar generally as an aberrational decision" (*id.* at 20). Respondents' suggestion is wholly unsatisfactory.

First, far from being a "sport,"[2] *Shimberg* reflects the weight of authority on this issue. As we noted in our petition (at 14-16), a consistent line of court of appeals decisions dating back to 1934 has held that boot received in a reorganization on a pro rata basis by the shareholders of one of the corporations has the "effect of the distribution of a dividend" (I.R.C. § 356(a)(2)) and is to be taxed as such. It would be quite extraordinary for the IRS to react to the decision of the court of appeals below by abandoning a longstanding position that reflects the state of the law in five circuits, particularly when the reasoning below does not weaken the IRS's conviction that *Shimberg* represents the correct interpretation of the law.[3]

---

[2] At least one commentator describes the logic of *Shimberg* as "unassailable" in the context of a pro rata distribution, which is what is involved in this case. See Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 Tax L. Rev. 297, 324 (1984).

[3] While it would be inappropriate to engage in an extended discussion of the merits here, we must respond briefly to respondents' repeated assertion (see Br. in Opp. 11 n.12, 13-14 & n.15) that the government's scenario for tax purposes diverges somewhat from what actually happened by allegedly treating the boot as a pre-reorganization dividend. The court of appeals similarly observed (Pet. App. 8a) that *any* analysis for tax purposes must make an assumption that is somewhat unrealistic, because it must view the transaction as if "the boot was received either before or after the reorganization"

In any event, even if the IRS were to reverse its position and adopt the view of the court below, that would not alleviate the administrative difficulties that have impelled us to seek certiorari here. As we have noted, the new position that respondents urge the IRS to take would have the effect of denying to corporate shareholders the intercorporate dividend deduction, and such shareholders would have a strong interest in challenging that position in litigation. Respondents suggest that only a "hardy corporate

(*ibid.*), when in fact it was received in the course of the reorganization. Even if that premise is accepted for purposes of argument, however, the *Shimberg* analysis more closely approximates the actual facts than does the analysis of the court below. Respondents, after all, did in fact receive a distribution of cash in the amount of the earnings and profits that they had accumulated in Basin, which is what the *Shimberg* dividend treatment hypothesizes. By contrast, they never received the NL stock whose redemption was hypothesized by the court below; indeed, as we emphasized in our petition (at 22), the scenario hypothesized by the court below is precisely the option that respondents deliberately chose not to exercise.

Respondents' repeated references to an "integrated approach" (Br. in Opp. 12) appear to suggest that the boot should be viewed as a "payment" (*id.* at 14 n.15) to purchase their Basin stock. Of course, gain from a *sale* of a capital asset is capital gain and, in the absence of Section 356, all of the more than $10 million of gain realized upon the Basin-NL transaction would have been recognized and currently taxed as capital gain. But respondents here sought to have the transaction treated not as a sale, but as a tax-free reorganization under Section 356. See Kyser, *supra,* 39 Tax. L. Rev. at 325-326. The premise of that tax-free treatment is the continuing interest of the participating shareholders in the reorganized entity, and Congress recognized in enacting Section 356 that another consequence of that continuing interest is that boot distributions can have the effect of dividends. Congress could have provided that boot should be taxed on the basis of a hypothetical redemption following a pure stock-for-stock reorganization, but it did not choose to do so. Instead, it provided that a boot distribution that has the effect of a dividend, like the pro rata distribution in this case, should be taxed as a dividend.

taxpayer indeed" (Br. in Opp. 21) would challenge the IRS's unfavorable tax treatment, "even in the Fifth and Twelfth [*sic*] Circuits in which *Shimberg* is nominally authority" (*id.* at 21-22). That suggestion is unduly optimistic, to say the least. It would be surprising if no corporate shareholder, armed with the IRS's prior position and the long line of court of appeals authority we have noted, were willing to litigate an adverse determination by the IRS grounded in the decision below, especially in the five circuits in which the controlling authority would be in the taxpayer's favor.[4] What appears to be respondents' fallback suggestion (see Br. in Opp. 21 n.27)—that the IRS not contest such litigation and thereby permit both corporate and individual shareholders to have the (inconsistent) tax treatment that they desire—cannot be reconciled with the Commissioner's duty to protect the public fisc. In

[4] A recent decision of the Ninth Circuit, *Tribune Publishing Co.* v. *United States*, No. 86-3734 (Jan. 6, 1988), provides one example of a suit brought by a corporate shareholder to obtain dividend treatment for boot received in a reorganization. There, the shareholders of the acquired corporation originally received only shares of stock in the acquiring corporation. Later, shareholders successfully sued the surviving corporation for securities fraud in connection with the reorganization and recovered cash and newsprint discounts. They contended that this recovery was a "boot dividend" under Section 356(a)(2); the IRS took the position that the cash and discounts were not received "in pursuance of the plan of reorganization" (I.R.C. §§ 354, 356). When the court of appeals rejected that contention, it necessarily followed that the payment of cash had the effect of a dividend, and the corporate shareholder was entitled to the favorable dividend treatment it sought. Of course, there are no such recent cases brought by corporate shareholders that are directly on point here; because the IRS has consistently maintained the "*Shimberg* position," as long as it has agreed that the transaction qualifies as part of a reorganization, corporate shareholders have received the tax treatment they desire on the issue presented here without any need to resort to litigation.

short, even if it would be appropriate for the IRS to reverse its longstanding position on this issue and reject the majority view of the courts of appeals, that course of action would still leave it facing repeated litigation with no end in sight until the conflict in the circuits is resolved.

2. Respondents also contend (Br. in Opp. 15-16) that the Court should deny certiorari because the Treasury Department did not oppose a recent legislative proposal that, if enacted, would have embodied in the statute, inter alia, the result reached by the court below. That proposal was not enacted, however, and respondents attribute unwarranted significance to Treasury's failure to oppose it. The legislative proposal was a major revision of numerous provisions of Subchapter C of the Internal Revenue Code, which relates to corporate distributions and reorganizations. The Treasury Department's comments on the proposed draft included a discussion of the proposal to adopt the hypothetical "after-the-fact" redemption approach that forms the basis for the decision below. The Department's comments stated that "[r]esolution of this issue is a very close call," followed by a discussion of the relative merits of each position, which seems to tilt toward the *Shimberg* approach. See *Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 24-25 (1983) [hereinafter *Senate Hearing*]. The Treasury Department's comments then concluded (*id.* at 25): "On balance, we do not object to the Staff's recommended approach in the context of the overall project."[5]

[5] The "overall project" contained many provisions that would have varying effects on the government's tax collections. Thus, while the proposal relevant to this case could have been expected, at least in the case of individual shareholders, to have the effect of reducing the number of "boot dividends" that would be recognized, other aspects of the Subchapter C revision would have had the effect of increasing the amount of dividends recognized. For example, the proposed revision would have relaxed two existing limitations on the amount of a boot dividend—the amount of gain realized and earnings and profits. See *Senate Hearing* 24-25; Staff of the Senate Comm. on Finance, 98th Cong., 1st Sess., *S. Prt. 98-95, The Reform and Simplification of the Income Taxation of Corporations* 63 (Comm. Print 1983); see generally Kyser, *supra*, 39 Tax L. Rev. at 322-323.

Accordingly, the Treasury Department's comments on that legislative proposal (which was not sponsored by the Department) do not remotely suggest that Treasury has ever viewed the *Shimberg* approach as "incorrect" (cf. Br. in Opp. 16). To the contrary, the government has consistently maintained the interpretation of existing law that is reflected in our petition for certiorari.[6] The fact that

[6] Respondents assert (Br. in Opp. 22-24) that the government has not taken a consistent position on the question presented here, and that certiorari should not be granted until the issue "is resolved within petitioner's own ranks" (*id.* at 22). There is no substance to this accusation. The government has consistently maintained that a pro rata distribution to the shareholders of the acquired corporation "has the effect of the distribution of a dividend" under Section 356(a)(2). As we noted in our petition (at 19 n.12), both the IRS in its rulings and the *Shimberg* court recognized that Section 302 principles may play a role in resolving whether dividend treatment is appropriate in some cases, and those statements are fully consistent with our position here. As we also explained in the petition (at 19 & n.12), however, invocation of Section 302 is significant only in the case of a non-pro-rata distribution. In the case of a pro rata distribution like the one here, the distribution is clearly a dividend whether or not one refers to Section 302; focusing on the abstract question whether Section 302 principles apply is only a confusing distraction. See Kyser, *supra*, 39 Tax L. Rev. at 309. Indeed, the extent to which the abstract question of the application of Section 302 principles is a "red herring" in the pro rata distribution context involved here is demonstrated by respondents' own brief. The cases that respondents rely upon to demonstrate that Section 302 principles apply here are precisely the same cases upon which the government has relied (and which respondents have ignored) in showing the consistent line of authority recognizing that pro rata boot distributions should be treated as a dividend (compare Br. in Opp. 8 with Pet. 14-15).

Treasury did not object, "in the context of the overall project," to a legislative proposal that would codify the result below is quite irrelevant to whether certiorari should be granted here. As discussed at the outset, the reasons why the government has sought certiorari in this case pertain to the existence of a conflict in the circuits that creates serious uncertainty in the tax treatment of corporate reorganizations and that places the IRS in an administrative quandary. We would "accept[]" (Br. in Opp. 16)—indeed, welcome—a legislative resolution of that conflict, but there appears to be no reasonable likelihood of such legislative action in the foreseeable future.

As the Tax Court noted (Pet. App. 30a n.9), there have been numerous legislative proposals, dating back to 1954, to amend the Internal Revenue Code to address more explicitly the question of "boot dividends." Some of these proposals would have adopted the approach reflected in the decision below; others would have adopted the *Shimberg* approach. What the proposals have in common is that none of them were enacted into law, and there is no reason to believe that we are any closer to a legislative resolution of this dilemma than we were in 1954 when the first proposal was introduced. Thus, it appears to be left to the courts to decide under existing law cases raising the

issue presented here. Because of the substantial administrative problems, as well as further litigation, that will be engendered by the conflict in the circuits created by the decision below, we believe that resolution of the conflict by this Court is necessary.

For the foregoing reasons and those stated in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED
Solicitor General

MARCH 1988

U.S. GOVERNMENT PRINTING OFFICE: 1988—202-037/60324

Supreme Court, U.S.
FILED
APR 7 1988
JOSEPH F. SPANIOL, JR.
CLERK

(4)

No. 87-1168

In the Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

JOINT APPENDIX

WALTER B. SLOCOMBE
DANIEL B. ROSENBAUM
Caplin & Drysdale
One Thomas Circle, N.W.
Suite 1200
Washington, D.C. 20005
Counsel for Respondents

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217
Counsel for Petitioner

PETITION FOR A WRIT OF CERTIORARI
FILED JANUARY 11, 1988
CERTIORARI GRANTED MARCH 7, 1988

69 pp

In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-1168

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

JOINT APPENDIX

TABLE OF CONTENTS*

		Page
1.	Relevant docket entries in the court of appeals ..	1
2.	Relevant docket entries in the Tax Court	4
3.	Petition (with attachments)	7
4.	Answer	23
5.	First stipulation for trial	25
6.	Stipulation exhibit G—Schedule of federal income tax return of Basin Surveys, Inc. for period beginning 2/1/79 and ending 4/18/79 .	30

---

* The opinions and orders of the court of appeals and the Tax Court are printed in the appendix to the petition for a writ of certiorari and have not been reproduced here.

7. Second stipulation for trial 33
8. Transcript of 5/1/84 Tax Court hearing 35
9. Decision of Tax Court 66
10. Order granting certiorari 68

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 86-1736

DONALD E. CLARK AND PEGGY S. CLARK,
PLAINTIFFS-APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE,
DEFENDANT-APPELLANT

DOCKET ENTRIES

DATE	PROCEEDINGS
12/22/86	Docketing statement filed by Appellant [47662-1]. T/S needed: y; T/S already on file y. [86-1736] (dhb) [Entry date 12/23/86]
12/23/86	Tax case docketed. (dhb)
12/23/86	Docketing notice issued. [86-1736] (dhb)
2/9/87	Record on appeal filed. (Pleadings: Vol. I T/S: Vol. II Exhibits: Vol. III (jacket)). [86-1736] (dhb)
2/9/87	Briefing order filed. A/P brief due: 03/23/87 Projected calendar: June 1987 [86-1736] (dhb)
3/23/87	Brief and joint appendix filed by Appellant. Type of Service: CS, Copies of brief: 12, Copies of apx: 6. [86-1736] (eac) [Entry date 3/24/87]
4/1/87	Case referred to OSC for screening. [86-1736] (ski)

4/2/87 OSC case referred to clerk for calendaring. [86-1736] (vsl)

4/16/87 Case tentatively calendared for oral argument Term: June Place: Richmond. [86-1736] (ski)

4/28/87 Case calendared for oral argument. [86-1736] (ski)

4/28/87 Brief received without filing from Appellee Donald E. Clark. [86-1736] (wtc)
[Entry date 4/29/87]

5/6/87 Motion filed by Appellee to allow attachment to brief as a supplement [77471-1]. [86-1736] (dhb)

5/12/87 Reply brief filed by Appellant. Type of Service: cs Copies: 12. [86-1736] (ks)
[Entry date 5/14/87]

5/21/87 Court order filed by KKH, JHW, FNS granting motion to allow attachment to brief [77471-1] Copies to attorney for Appellee, attorney for Appellant. [86-1736] (dhb)
[Edit date 9/8/87]

5/21/87 Brief filed by Appellee. Type of Service: G, Copies: 12. [86-1736] (ks)

6/3/87 Oral argument heard. Courtroom Deputy: jlc. [86-1736] (jc)

9/4/87 Per Curiam opinion (P) filed. Panel: KKH, JHW, Writing Judge, FNS; Decision: affirmed. [86-1736] (bhr)

9/4/87 Judgment order filed. [86-1736] (bhr)

9/25/87 Mandate issued. [86-1736] (emb)

9/25/87 Record on appeal returned to U.S. TAX COURT. (Pleadings: VOLUME I T/S: VOLUME II Exhibits: VOLUME III). [86-1736] (emb)

10/19/87 Federal Reporter Citation: 828 F.2d 221. [86-1736] (elf)
[Entry date 11/4/87]

1/19/88 Supreme Court notice received of filing of petition for certiorari on 01/11/88. Supreme Court No. 87-1168. [86-1736] (emb)
[Entry date 1/22/88]

3/10/88 Supreme Court order filed granting petition for certiorari. [86-1736] (jm)
[Entry date 3/11/88]

UNITED STATES TAX COURT

No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DOCKET ENTRIES

DATE	FILINGS AND PROCEEDINGS
Apr. 26, 1983	PETITION FILED: FEE PAID Date Served Apr. 28, 1983
Apr. 26, 1983	REQUEST by Petrs. for trial at Washington, DC GRANTED Apr 26, 1983 Date Served Apr 28, 1983
May 20, 1983	ANSWER by Resp. (C/S 5/18/83)
Feb. 2, 1984	NOTICE OF TRIAL on April 23, 1984 at Washington, D.C. Date Served Feb. 2, 1984
Apr. 2, 1984	FIRST STIPULATION FOR TRIAL PREAMBLE filed. (Exhibits attached)
Apr. 23, and May 1, 1984	TRIAL at Washington, D.C. before Judge Tannenwald. Second Stipulation for trial with att'd exhibits filed May 1, 1984. ORIGINAL BRIEFS DUE: August 29, 1984

	REPLY BRIEFS DUE: Oct. 29, 1984 SUBMITTED TO JUDGE TANNENWALD.
May 24, 1984	TRANSCRIPT for May 1, 1984 received.
Aug. 29, 1984	BRIEF for Resp. filed. Date Served Aug 30, 1984
Aug 29, 1984	BRIEF for Petr. filed Date Served Aug 30, 1984
Sept 18, 1984	JOINT MOTION to correct transcript. Action Granted Sept. 20, 1984 Date Served Sept. 24, 1984
Oct. 26, 1984	REPLY BRIEF for Resp. filed. Date Served Oct. 30, 1984
Oct. 29, 1984	REPLY BRIEF For Petr. filed. Date Served Oct. 30, 1984
Feb. 6, 1986	FINDINGS OF FACT OPINION filed, Judge Tannenwald. Decision will be entered under Rule 155. Date Served Feb. 6, 1986
Mar. 7, 1986	ORDER, that the Opinion filed on Feb. 6, 1986, to be amended as follows: Delete pages 24, 26, 29, 31, and substitute attached pages 24, 26, 29, and 31. Date Served Mar. 14, 1986
Sept 9, 1986	AGREED COMPUTATION filed.
Sept 18, 1986	DECISION ENTERED, Judge Tannenwald. Date Served Sept. 18, 1986
	APPELLATE PROCEEDINGS
Dec 16, 1986	NOTICE OF APPEAL to U.S.C.A., 4th Cir., filed by Resp. Date Served Dec 17, 1986

Dec 17, 1986	NOTICE of Filing with copy of notice of appeal mailed to counsel of record for petrs. Date Served Dec 17, 1986
Dec 17, 1986	NOTICE, to parties, of assembling and date for transmission of record. Date Served Dec 17, 1986

UNITED STATES TAX COURT

No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION

The petitioners hereby petition for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (symbols: AP:LO:JDT:DL) dated February 3, 1983, and as the basis of their case allege as follows:

1. Petitioners are husband and wife and now maintain their legal residence at 4 Kent Street, Buckhannon, West Virginia 26201. Petitioners timely filed a joint federal income tax return for their taxable year ended December 31, 1979 with the Internal Revenue Service Center at Memphis, Tennessee. Their social security numbers are 324-28-2334 and 320-30-8857, respectively. References hereinafter to "Petitioner" or to "Clark" refer to Donald E. Clark.

2. The notice of deficiency (a copy of which is attached hereto and marked Exhibit "A") was mailed to petitioners on February 3, 1983 and was issued by the Office of the Internal Revenue Service at Louisville, Kentucky.

3. The deficiency as determined by the Commissioner is in income tax for calendar year 1979 in the amount of $972,504.74. All of said deficiency is in dispute.

4. The determination of tax set forth in said notice of deficiency is based on the following error:

(a) The Commissioner erred in determining that Petitioner received dividend income in the amount of $2,319,611 when he exchanged all of the outstanding stock of Basin Surveys, Inc. (hereinafter "Basin Surveys") for 300,000 shares of common stock of NL Industries, Inc. (hereinafter "NL") and $3,250,000 cash.

5. The facts upon which petitioners rely as the basis of their case are as follows:

(a) Until April 18, 1979, Petitioner owned all of the outstanding stock of Basin Surveys.

(b) On April 18, Basin Surveys was merged, pursuant to the provisions of state law, into NL Acquisition Corporation, a wholly-owned subsidiary of NL. The transaction qualified as a "reorganization" under sections 368(a)(1)(A) and 368(a)(2)(D) of the Internal Revenue Code of 1954, as amended.

(c) At the final stage of the negotiations which led to the merger, NL offered Petitioner a choice among alternative forms of payment for his Basin Surveys stock. Petitioner could either receive 425,000 shares of NL common stock as the sole consideration or he could receive 300,000 shares of NL common stock and $3,250,000 in cash in lieu of the additional NL shares.

(d) Petitioner chose to receive, and did receive, in exchange for his Basin Surveys stock, 300,000 shares of NL common stock and, in addition, $3,250,000 cash instead of an additional 125,000 shares of NL common stock.

(e) As of the end of March 1979, NL had outstanding approximately 32,533,000 shares of common stock and 500,000 shares of preferred stock. Hence, after the merger, Clark owned approximately 0.92%

of all outstanding NL common stock. If, in contrast, he had chosen the all-stock deal and received an additional 125,000 shares of NL common stock, he would have owned approximately 1.3% of all outstanding NL common stock. By taking cash, he reduced his stock ownership of NL to 70.6% of what it would have been if no cash had been involved.

(f) As of April 18, 1979, Basin Surveys had total assets of $2,758,069 and liabilities of $808,132, as reported on Schedule L of its federal income tax return for its short taxable year ended on that date. Among its assets were $138,490 in cash, $1,231,552 in trade notes and accounts receivable (after allowance for bad debts) and buildings and other fixed depreciable assets with a book value (after accumulated depreciation) of $929,306.

(g) The payment of cash by NL to Petitioner as part of the consideration for his Basin Surveys stock did not, in whole or in part, have the effect of the distribution of a dividend.

WHEREFORE, petitioners pray that the Court determine that no deficiency exists in their income taxes for their taxable year ended December 31, 1979 and that the Court grant such other and further relief as it may deem proper.

/s/ WALTER B. SLOCOMBE
Walter B. Slocombe

/s/ DANIEL B. ROSENBAUM
Daniel B. Rosenbaum

/s/ DANIEL M. DAVIDSON
Daniel M. Davidson
Counsel for Petitioners
Caplin & Drysdale, Chartered
1101 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 862-5000

Date of Signatures: April 26, 1983

Exhibit A

Internal Revenue Service
Department of the Treasury

Date: Feb 03 1983

Mr. Donald E. Clark and
Mrs. Peggy S. Clark
4 Kent St.
Buckhannon, WV 26201

CERTIFIED MAIL NO.
1016-652

Social Security or
Employer Identification
Number:
324-28-2334
Tax Year Ended and
Deficiency:

December 31, 1979
$972,504.74

Person to Contact: Jack D. Taylor
Contact Telephone Number: (304) 422-8551, ext. 1289

Dear Mr. and Mrs. Clark:

We have determined that there is a deficiency (increase) in your income tax as shown above. This letter is a NOTICE OF DEFICIENCY sent to you as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside of the United States) to file a petition with the United States Tax Court for a redetermination of the deficiency. The petition should be filed with the United States Tax Court, 400 Second Street NW., Washington, D.C. 20217, and the copy of this letter should be attached to the petition. The time in which you must file a petition with

the Court (90 to 150 days as the case may be) is fixed by law and *the Court cannot consider your case if your petition is filed late.* If this letter is addressed to both a husband and wife, and both want to petition the Tax Court, *both* must sign the petition or each must file a separate, signed petition. You can get a copy of the rules for filing a petition by writing to the Clerk of the United States Tax Court, at the address shown in this paragraph.

If you decide not to file a petition with the Tax Court, we would appreciate it if you would sign and return the enclosed waiver form. This will permit us to assess the deficiency quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience. If you decide not to sign and return the waiver and you do not timely petition the Tax Court, we will assess and bill you for the deficiency after 90 days from the above mailing date of this letter (150 days if this letter is addressed to you outside the United States).

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely yours,

/s/ ROSCOE L. EGGER, JR.
Roscoe L. Egger, Jr.
Commissioner

By
H. LARRY STEWART
H. Larry Stewart
Associate Chief
Louisville Appeals Office

Enclosures:
Copy of this letter
Statement
Waiver
Envelope
cc: Daniel B. Rosenbaum
Donald B. Nestor
P.O. Box 1588,
Louisville, KY 40201

Letter 894(RO) (Rev. 4-82)

Form 4089 Symbols
(Rev. April 1979) AP:LO:JDT:DL
Department of the Treasury—Internal Revenue Service
Notice of Deficiency-Waiver

Name and Address of Taxpayer(s)
Mr. Donald E. Clark and
Mrs. Peggy S. Clark
4 Kent Street
Buckhannon, WV 26201

Kind of Tax Income

Copy to Authorized Representative
Mr. Daniel B. Rosenbaum
1101 17th St., N.W.
Washington, DC 20036

Mr. Donald B. Nestor, CPA
Toothman, Rice & Co.
Professional Arts Plaza
Buckhannon, WV 26201

Taxable Year Ended December 31, 1979

Increase in Tax $972,504.74

See the attached explanation for the above deficiencies

I consent to the immediate assessment and collection of the deficiencies (increased in tax and penalties) shown above, plus an interest provided by law.

Your signature ► ..... _____
(Date signed)

Spouse's Signature,
If A Joint Return
Was Filed ► ..... _____
(Date signed)

Taxpayer's Representative
Sign Here ► ..... _____
(Date Signed)

Corporate Name: ► .....

Corporate Officers ► .....
(Signature) (Title) (Date signed)

Sign Here ► .....
(Signature) (Title) (Date signed)

Note:

If you consent to the assessment of the amounts shown in this waiver, please sign and return it in order to limit the accumulation of interest and expedite our bill to you. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are entitled to a refund; nor prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.

If you later file a claim and the Internal Revenue Service disallows it, you may file suit for refund in a district court or in the United States Court of Claims, but you may not file a petition with the United States Tax Court.

Who Must Sign

If this waiver is for any year(s) for which you filed a joint return, both you and your spouse must sign the original and duplicate of this waiver form unless one of you are acting under a power of attorney, signs as agent for the other.

This waiver may be signed by your attorney or agent provided such action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (such as executor, administrator, trustee), Form, Notice of Fiduciary Relationship, should, unless previously filed, accompany this form,

If this waiver is for a corporation, it must be signed with the corporate name followed by the signautre and title of the officer(s) authorized to sign.

If you agree, please sign one copy and return it; keep the other copy for your records.

Form 4089 (Rev.)

Form 5278 1040
(Rev. May 1978) 1

Statement – Income Tax Changes

Name(s) of Taxpayer(s)
Mr. Donald E. Clark and
Mrs. Peggy S. Clark

☒ Notice of Deficiency
☐ Settlement Computation ☐ Other (*specify*)

	Tax Years Ended 12/31/79
1. Adjustments to income	
a. Dividends	2,319,611.00
b. Capital Gain	(905,962.00)
c. Interest Income	63,647.00
d. Rental Depreciation	2,000.00
e.	
f.	
g.	
2. Total adjustments	1,479,296.00
3a. ☒ Table income ☐ Adjusted gross income	
b. As shown in: ☐ Tax table income	
☐ Preliminary letter dated _____ ☐ Notice of deficiency dated _____	
☒ Return as filed	1,316,256.00
4. ☒ Taxable income as revised	
☐ Adjusted gross income as revised	
☐ Tax table income as revised	2,795,552.00

5. Tax from	
☐ Tax tables	
☒ Schedule 2	
☒ Tax rate schedules	1,910,096.74
6. Alternative tax if applicable (*from page _____*)	
7. Tax surcharge	
8. Corrected tax liability (*lesser of line 5 or 6, plus line 7*)	
9. Less credits *(specify)*	
a Investment, return	1,551.00
b.	
c.	
10. Balance *(line 8 less amounts on lines 9a through 9c)*	1,908,545.74
11. Plus	
a. Tax from recomputing prior year investment credit	
b. Self-employment tax	
c. Minimum tax	0
12. Total corrected income tax liability *(line 10 plus amounts on lines 11a through 11c)*	1,908,545.74
13. Total tax as previously adjusted*	936,041.00
14. Increase in tax *(difference between lines 12 and 13)*	972,504.74
15. Additions to the tax *(listed below)*	
*Tax per return	893,533.00
Additional assessment 01-06-83	42,508.00
Tax as previously adjusted	936,041.00

Form 886-A
(Rev April 1968)

Schedule No. 1a

EXPLANATION OF ITEMS

Name of Taxpayer
Mr. Donald E. Clark and
Mrs. Peggy S. Clark

Year/Period Ended
12/31/79

(a) It is determined, pursuant to Internal Revenue Code section 356, that you received dividend income in the amount of $2,319,611.00 when you transferred your stock in Basin Surveys, Inc., and a five-year covenant not to compete in exchange for 300,000 shares of NL Industries, and $3,250,000 cash "boot". Accordingly, your taxable income is increased $2,319,611.00. See computation below:

(b) It is determined that your long-term capital gain from the exchange of your stock in Basin Surveys, Inc., for the stock of NL Industries is $930,389.00 in lieu of $3,195,294.00 shown in your return. Therefore, your taxable gain is decreased $905,962.00, as detailed below.

Form 886-A
(Rev. April 1968)

Schedule No. 1a (cont'd)

EXPLANATION OF ITEMS

Name of Taxpayer
Mr. Donald E. Clark and
Mrs. Peggy S. Clark

Year/Period Ended
12/31/79

Exchange of stock:		
N.L. Industries stock – fair market value	$6,000,000.00	
Cash boot	3,250,000.00	$9,250,000.00
Basin Surveys, Inc., stock adjusted basis	$ 84,515.00	
Cost	25,013.00	109,528.00
Gain realized		$9,140,472.00
		Dividend Income
Gain recognized	$3,250,000.00	
Less: Dividends as determined, See Item (a) above	(2,319,611.00)	$2,319,611.00
Per return		-0-
Increase taxable income		$2,319,611.00
		Capital Gain
Long-term capital gains		
Basin Surveys, Inc., stock	$ 930,389.00	
Other, per return	3,399.00	
Net capital gain as determined		$ 933,788.00
Less: Section 1202, Internal Revenue Code, deduction		(560,273.00)
Taxable gain as determined		$ 373,515.00
Taxable gain per return		1,279,477.00
Decrease taxable income		905,962.00

Form 886-A (Rev April 1968) — Schedule No. 1a (cont'd)

EXPLANATION OF ITEMS

Name of Taxpayer: Mr. Donald E. Clark and Mrs. Peggy S. Clark

Year/Period Ended: 12/31/79

(c) It is determined that you received interest income in the amount of $211,940.00 in lieu of $148,293.00 shown in your return. Accordingly, your taxable income is increased $63,647.00.

(d) It is determined that your deduction for depreciation on a building with a basis of $25,000.00, 25-year life, under the straight line method is $1,000.00 in lieu of $3,000.00 shown on your return. Accordingly, your taxable income is increased $2,000.00.

(c) and (d) Agreement to these adjustments was indicated by execution of Form 870, Waiver of Restrictions on Assessments and Collection of Deficiency in Tax and Acceptance of Overassessment, received by the Chief, Appeals Office, Louisville, Kentucky, on November 30, 1982.

SCHEDULE G (Form 1040) — **1979** — 18

Department of the Treasury
Internal Revenue Service

Income Averaging

► See instructions on pages 2 and 3.
► Attach to Form 1040

Name(s) as shown on Form 1040: Mr. Donald E. Clark and Mrs. Peggy S. Clark

Your social security number: 324-28-2334

Base Period Income and Adjustments	(a) 1st preceding base period year 1978	(b) 2d preceding base period year 1977	(c) 3rd preceding base period year 1976	(d) 4th preceding base period year 1975
1 Enter amount from: Form 1040 (1977 and 1978) – line 34 Form 1040A (1977 and 1978) – line 10	141,122.00	138,722.00		
2 Multiple $750 by the total number of exemptions claimed in 1977 and 1978	1,500.00	1,500.00		
3 Taxable income (subtract line 2 from line 1) If less than zero, enter zero (see instructions)	139,622.00	137,222.00	87,296.00	41,993.00
4 Income earned outside of the United States or within U.S. possessions and excluded under sections 911 and 931				
5 On your 1979 Form 1040, if your checked box 2 or 5 enter $3,200; 1 or 4 enter $2,200; 3 enter $1,600 in columns (c) and (d)			3,200.00	3,200.00
6 Base period income (add lines 3, 4 and 5)	139,622.00	137,222.00	90,496.00	45,193.00

Computation of Averageables Income

7 Taxable income for 1979 from Schedule TC (Form 1040), Part I, line 3	7	2,795,552.00		
8 Certain amounts received by owner-employees subject to a penalty under section 72(m)(5)	8			
9 Subtract line 8 from line 7	9	2,795,552.00		
10 Excess community income	10			
11 Adjusted taxable income (subtract line 10 from line 9). If less than zero, enter zero			11	2,795,552.00
12 Add columns (a) through (d), line 6, and enter here	12	412,533.00		
13 Enter 30% of line 12			13	123,759.90
14 Averageable income (subtract line 13 from line 11)			14	2,671,792.10

If line 14 is $3,000 or less, do not complete the rest of the form. You do not qualify for income averaging.

Computation of Tax

15	Amount from line 13		15	123,759.90
16	20% of line 14		16	534,358.42
17	Total add lines 15 and 16)		17	658,118.32
18	Excess community income from line 10		18	
19	Total (add lines 17 and 18)		19	658,118.32
20	Tax on amount on line 19 (see caution below)		20	427,406.82
21	Tax on amount on line 17 (see caution below)	21 427,406.82		
22	Tax on amount on line 15 (see caution below)	22 56,734.34		
23	Subtract line 22 from line 21	23 370,672.48		
24	Multiply the amount on line 23 by 4		24	1,482,689.92
	Note: *If no entry was made on line 8 above, skip lines 25 through 27 and go to line 28.*			
25	Tax on amount on line 7 (see caution below)	25		
26	Tax on amount on line 9 (see caution below)	26		
27	Subtract line 26 from line 25		27	
28	Tax (add lines 20, 24, and 27). Enter here and on Schedule TC (Form 1040), Part I, line 4 and check Schedule G box		28	1,901,096.74

Caution: Use Tax Rate Schedule X, Y or Z from the Form 1040 instructions to figure your tax on lines 20, 21, 22, 25 and 26. Do not use the tax tables.

UNITED STATES TAX COURT

Docket No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1., 2., and 3. Admits.

4. (a). Denies the respondent erred as alleged in subparagraph (a) of paragraph 4 of the petition.

5. (a). Admits.

5. (b). Denies information or knowledge sufficient to form a belief as to the truth of the allegations in subparagraph (b) of paragraph 5 of the petition.

5. (c). Denies.

5. (d). Admits petitioner received, in exchange for his Basin Surveys stock, 300,000 shares of NL common stock and, in addition, $3,250,000 cash; denies the remaining allegations of subparagraph (d) of paragraph 5 of the petition.

5. (e). Denies information or knowledge sufficient to form a belief as to the truth of the allegations in subparagraph (e) of paragraph 5 of the petition.

5. (f). Admits that Schedule L of Basin Surveys' federal income tax return as of April 18, 1979, reflects assets of $2,758,069, liabilities of $808,132, cash of $138,490, trade notes and accounts receivable (net of

reserve for bad debts) of $1,231,552, and fixed assets (net of accumulated depreciation) of $929,306; denies knowledge sufficient to form a belief as to the truth of the contents of said Schedule L.

5. (g) Denies.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified, or denied.

WHEREFORE, it is prayed that the deficiency determined by the respondent be in all respects approved.

KENNETH W. GIDEON
Chief Counsel
Internal Revenue Service

By: CONLEY G. WILKERSON
Conley G. Wilkerson
Acting District Counsel

May 18, 1983

OF COUNSEL:
VERNON J. OWENS
Regional Counsel
LARRY L. NAMEROFF
Senior Attorney
Internal Revenue Service
7525 Federal Office Building
550 Main Street
Cincinnati, OH 45202
Tel. No. 513-684-3211

INITIALLED

UNITED STATES TAX COURT

Docket No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

FIRST STIPULATION FOR TRIAL PREAMBLE

In accordance with Tax Court Rule 91(e), the below-signed parties agree to this FIRST STIPULATION FOR TRIAL pursuant to the general terms of this preamble, *unless specifically expressed otherwise.*

A. All stipulated facts shall be conclusive.

B. The *EXHIBIT LIST* (Appendix I) identifies exhibits. Without further words of inclusion, all listed exhibits are expressly incorporated as part of this stipulation. Except as noted, each incorporated exhibit is authentic and admissible as evidence for any relevant purpose.

C. Except for relevancy, all objections to this stipulation and its exhibits are expressly waived unless stated in this stipulation.

D. The *GLOSSARY* below defines special words which appear in capital letters.

TERM	*DEFINITION*
NL	N.L. Industries, Inc.
BASIN	Basin Surveys, Inc.
NLAC	N.L. Acquisition Corp.
MERGER	April 18, 1979 merger of BASIN into NLAC
PLAN	Agreement and Plan of Merger dated April 3, 1979

1. At the time of the filing of the petition, petitioners, Donald E. and Peggy S. Clark, resided at 4 Kent Street, Buckhannon, West Virginia 26201.

2. Petitioners are husband and wife. They timely filed a joint Federal income tax return for 1979 with the Memphis Service Center. (Exhibit B).

3. On February 3, 1983, respondent issued a statutory notice of deficiency (Exhibit A) for 1979 to petitioners determining a deficiency of $972,504.74 based upon the following adjustments:

Dividends	$2,319,611.00
Capital Gain	(905,962.00)
Interest Income	63,647.00
Rental Depreciation	2,000.00
Total	$1,479,296.00

4. Petitioners have previously conceded the interest income and rental depreciation adjustments, and an assessment based on these adjustments was made on January 6, 1983.

5. The sole issue for decision by the Court is whether the payment of cash in the amount of $3,250,000.00 by NL to Donald Clark which he received in the MERGER of BASIN into NLAC on April 18,1979 as part of the consideration for his Basin stock had the effect of a distribution of a dividend under I.R.C. § 356(a)(2) to the extent of BASIN's accumulated undistributed earnings and profits. The dividends and capital gain adjustments set forth in the statutory notice of deficiency are interrelated adjustments stemming from this issue.

6. BASIN was incorporated under the laws of West Virginia in 1963. Its principal business was furnishing radiation, nuclear, and electronic open hole logging services to the petroleum industry.

7. Petitioner Donald Clark was the president of BASIN from 1964 until April 18, 1979.

8. NL is, and was at all times relevant to the MERGER, a New Jersey corporation engaged in manufacturing and supplying petroleum equipment and services, chemicals, and metals.

9. NL is, and was at all times relevant to the MERGER, a publicly held corporation whose stock is and was traded on the New York Stock Exchange and the Pacific Stock Exchange. As of the end of March 1979, NL had outstanding approximately 32,533,000 shares of its single class of common stock (par value $2.50 per share) and 500,000 shares of preferred stock. See Exhibit F.

10. NLAC was a 100% owned subsidiary of NL.

11. Prior to April 18, 1979, neither Donald Clark nor Peggy Clark owned any stock in NL or NLAC.

12. An Agreement and Plan of Merger dated April 3, 1979 (Exhibit C) (hereinafter referred to as the "PLAN") was executed by BASIN, NLAC, Clark, and NL.

13. The PLAN provided that on April 18, 1979, BASIN would merge with and into NLAC.

14. The PLAN provided that, at the effective time of the MERGER, each outstanding share of NLAC would remain outstanding, each outstanding share of BASIN common stock would be exchanged for $56,034.482 cash and 5,172.4137 shares of NL common stock, and each share of BASIN common stock held in the treasury of BASIN would be cancelled.

15. The PLAN further provided that the articles of incorporation of NLAC would be amended to change its name to Basin Surveys, Inc. at the effective time of the MERGER.

16. For the purposes of this case, the parties agree that the MERGER was effected pursuant to, and qualified as a "reorganization" under, I.R.C. §§ 368(a)(1)(A) and (a)(2)(D).

17. A Certificate of Merger issued by the Secretary of State of West Virginia, together with the attachment thereto, (Exhibit D) certifies the merger of BASIN into NLAC in accordance with West Virginia law.

18. Pursuant to the PLAN, Donald Clark signed a covenant not to compete for five years and an employment agreement to remain with Basin Surveys Inc. for three years. Executed copies of these documents appear as Exhibits C and D to Exhibit C attached hereto (Exhibit C, pp. 101-113).

19. Pursuant to the MERGER, Clark received $3,250,000.00 in cash and 300,000 shares of NL stock.

a. The closing price of NL common stock on the New York Stock Exchange on April 18, 1979 was $23-1/8 per share (Exhibit E).

b. Based on that closing price, the NL stock received by Clark had a value of $6,937,500 which constituted 68.1% of the total value of the consideration which Clark received for his BASIN stock.

c. Immediately after and as a result of the MERGER, Clark owned 300,000 shares of NL common stock constituting approximately 0.92% of all outstanding NL common stock.

d. Clark has at no time owned NL preferred stock.

20. Clark's basis for his BASIN stock immediately prior to the MERGER was $84,515. He incurred expenses of $25,013 in connection with the MERGER.

21. In their joint Federal income tax return for 1979, petitioners reported recognition of $3,195,294 of long term capital gain as a result of the MERGER.

22. As of April 18, 1979, BASIN had total assets of $2,758,069 and liabilities of $808,132. Among its assets were $138,490 in cash, $1,231,552 in trade notes and accounts receivable (after allowance for bad debts) and

buildings and other fixed depreciable assets with a book value (after accumulated depreciation) of $929,306. (Exhibit G).

23. As of April 18, 1979, BASIN had accumulated undistributed earnings and profits of $2,319,611.00.

In accordance with the above terms, the below-signed parties agree to this STIPULATION OF FACTS.

JOEL GERBER
Acting Chief Counsel
Internal Revenue Service

By: THOMAS C. MORRISON 30 Mar 84
Thomas C. Morrison Date
District Counsel
422 Universal North Bldg.
1875 Connecticut Ave., N.W.
Washington, D.C. 20009
(202) 376-0662

/s/ WALTER B. SLOCOMBE 20 Mar 84
Walter B. Slocombe Date

/s/ DANIEL B. ROSENBAUM 3/20/84
Daniel B. Rosenbaum Date

/s/ DANIEL M. DAVIDSON 3/20/84
Daniel M. Davidson Date
Caplin & Drysdale, Chartered
1101 17th St., N.W.
Washington, D.C. 20036
(202) 862-5000

STIPULATION EXHIBIT G–

Schedule L of Federal Income Tax Return of Basin Surveys, Inc. for period beginning February 1, 1979 and ending April 18, 1979

Form 1120 (1978)

Schedule L Balance Sheets	Beginning of taxable year		End of taxable year	
ASSETS	(A) Amount	(B) Total	(C) Amount	(D) Total
1 Cash		480,959		138,490
2 Trade notes and accounts receivable	973,418		1,270,785	
(a) Less allowance for bad debts	29,203	944,215	39,233	1,231,552
3 Inventories		91,932		91,932
4 Gov't obligations: (a) U.S. and instrumentalities				
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)		50,685		62,188
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)		15,000		53,072
9 Buildings and other fixed depreciable assets	1,884,144		1,934,089	
(a) Less accumulated depreciation	946,680	937,464	1,004,783	929,306
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)		70,500		70,500
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)		191,996		181,029
14 Total assets		2,782,751		2,758,069
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable		197,845		156,248
16 Mtges., notes, bonds payable in less than 1 yr.		93,538		93,940
17 Other current liabilities (attach schedule)		314,678		306,904
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more		182,956		182,214
20 Other liabilities (attach schedule)		68,826		68,826
21 Capital stock: (a) Preferred stock				
(b) Common stock	6,600	6,600	6,600	6,600
22 Paid-in or capital surplus		1,040		54,112
23 Retained earnings – Appropriated (attach sch.)				
24 Retained earnings – Unappropriated		2,110,125		2,082,082
25 Less cost of treasury stock		(192,857)		(192,857)
26 Total liabilities and stockholders' equity		2,782,751		2,758,069

Schedule M-1 Reconciliation of Income Per Books With Income Per Return

1 Net income per books	(14,971)	7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax		(a) Tax-exempt interest $_____	
3 Excess of capital losses over capital gains		C S V Life Ins	897
4 Income subject to tax not recorded on books this year (itemize)			
		8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (itemize)		(a) Depreciation $_____	
(a) Depreciation $_____		(b) Depletion	$2170
(b) Depletion $_____			2170
schedule attached	9,355	9 Total of lines 7 and 8	3067
6 Total of lines 1 through 5	(5616)	10 Income (line 28, page 1)—line 6 less 9	(8683)

Schedule M-2 Analysis of Unappropriated Retained Earnings Per Books (line 24 above)

1 Balance at beginning of year	2,110,125	5 Distributions: (a) Cash	
2 Net income per books	(14,971)	(b) Stock	
3 Other increases (itemize)		(c) Property	13,072
		6 Other decreases (itemize) to correct book balance as of date of distribution	
		7 Total of lines 5 and 6.	
4 Total of lines 1, 2, and 3	2,095,154	8 Balance at end of year (line 4 less 7)	2,082,082

UNITED STATES TAX COURT

Docket No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

SECOND STIPULATION FOR TRIAL

Pursuant to the terms and conditions set forth in the preamble to the First Stipulation, the parties agree to this Second Stipulation for Trial, as follows:

24. From on or about January 30, 1978 until the MERGER, Donald E. Clark was the sole shareholder of BASIN, owning all 58 of BASIN's outstanding shares of common stock.

25. As of January 1, 1978, Donald E. Clark owned 58 of 66 outstanding shares of BASIN common stock. The remaining 8 shares were owned by Jonathan B. Dagley, an employee of BASIN.

26. On January 16, 1978, Jonathan B. Dagley offered to sell his 8 shares of BASIN stock to BASIN, and the shareholders and directors of BASIN voted to accept this offer on January 30, 1978.

27. At all times after January 1964 until the MERGER, Donald E. Clark owned in excess of 85 percent of the outstanding common stock of BASIN.

28. At no time from the date of its incorporation until the MERGER has BASIN issued or been authorized to issue any stock other than a single class of common stock.

29. Attached hereto as Exhibits H through O are copies of the minutes of meetings of the shareholders and directors of BASIN showing the various changes in ownership of BASIN stock prior to the MERGER.

In accordance with the above terms, the below-signed parties agree to this Stipulation of Facts.

FRED T. GOLDBERG, JR.
Chief Counsel
Internal Revenue Service

By: THOMAS M. CRYAN/KEW 4/19/84
Thomas M. Cryan Date
Assistant District Counsel
Internal Revenue Service
422 Universal North Bldg.
1875 Connecticut Ave., N.W.
Washington, D.C. 20009
(202) 376-0662

Counsel for Respondent

Walter B. Slocombe Date

Daniel B. Rosenbaum Date

Daniel M. Davidson Date
Caplin & Drysdale, Chartered
1101 17th St., N.W.
Washington, D.C. 20036
(202) 862-5000

Counsel for Petitioners

UNITED STATES TAX COURT

Docket No. 9428-83

IN THE MATTER OF:
DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Tuesday, May 1, 1984
North Courtroom
400 2nd Street, NW
Washington, D.C.

The above-entitled matter came on for hearing, pursuant to notice, at 1:58 p.m.

BEFORE: HONORABLE THEODORE TANNENWALD, JR.
Judge

APPEARANCES:

On behalf of the Petitioner:

DANIEL B. ROSENBAUM, ESQUIRE
DANIEL M. DAVIDSON, ESQUIRE
WALTER B. SLOCOMBE, ESQUIRE
1101 Seventeenth Street, NW
Washington, D.C. 20036
(202) 862-5071

On behalf of the Respondent:

KATHLEEN E. WHATLEY, ESQUIRE
1875 Connecticut Avenue, NW
Washington, D.C.

THE CLERK: All rise. Please be seated. Docket No. 9428-83, Donald E. Clark and Peggy S. Clark.

Please state your appearances.

MS. WHATLEY: Kathleen Whatley for the Respondent. Good afternoon, Your Honor.

THE COURT: Good afternoon, Ms. Whatley.

MR. SLOCOMBE: Walter Slocombe for the Petitioner and—

MR. DAVIDSON: Daniel M. Davidson for the Petitioner.

MR. ROSENBAUM: Daniel B. Rosenbaum for the Petitioner.

THE COURT: Gentlemen. You have a stipulation of facts that you want to offer into evidence?

MS. WHATLEY: Yes, Your Honor. The parties have physically lodged with the Court our first stipulation of facts, paragraphs one through 23 and Exhibits A through G. In addition we have lodged with the Court a second stipulation of facts, paragraphs 24 through 29 and Exhibits H through O. I move that they be admitted into evidence at this time.

THE COURT: Have we got a second [4] stipulation?

All rights.

The stipulations of fact with exhibits noted are received in evidence and made part of the record of the case.

(The documents referred to, having been previously marked for identification as Exhibits A through O were received in evidence.)

THE COURT: Please be seated or stand if you wish. I have read the trial memorandum—memoranda. I think I understand the issue and it's really the question of trying to straighten out the Shimberg and the Wright cases, assuming they can be straightened out.

I understand, Ms. Whatley, from your trial memorandum that you have some problems with the testimony and I will let you voice your objections when the time comes. It seems to me though, – well, I'm not at all sure it's relevant because I take a somewhat different view of the situation. Certainly if you read Wright and if you read Judge Simpson's opinion in McDonald, prior negotiations and the attitude of the people has some bearing.

[5] In fact, if I read McDonald correctly, Judge Simpson even suggests that it may make a difference as to whether it was the taxpayer or the acquiring corporation that came up with the idea of cash instead of stock, in part. So on that basis it seems to me that the background of negotiations and the intention of the taxpayer may be relevant. I'm not convinced it is.

I think you have a question here as to forgetting all the negotiations and everything else. When a situation such as this arises where there is a significant reduction in ownership in terms of the acquiring interest of the taxpayer and the acquiring corporation, that may still produce capital gain.

As I read the Shimberg case, dispite the disclaimers to the contrary, I think the court is coming awful close to reinstating the automatic divident rule in this type of case, where you have a sole shareholder, or indeed, you have more than one shareholder, cash is allocated pro rata.

So I'm going to let the evidence in. You might have you objection if you want it.

MS. WHATLEY: Yes, Your Honor. I would like to make it just for the record.

THE COURT: All right.

[6] Let's see how the testimony goes and what I might do is just give you a running objection to all testimony. Is there going to be any testimony other than the background of the negotiations and the intention of Mr. Clark?

MR. SLOCOMBE: No, Your Honor.

THE COURT: Well then, why don't we leave it this way, Ms. Whatley, that you have a running objection to the testimony of all the Petitioners' witnesses on the grounds of relevancy and materiality which I overrule in advance and you have your exception.

MS. WHATLEY: Thank you, Your Honor.

THE COURT: The record's protected. We won't waste time.

I'm perfectly willing to make the trial memorandum part of the record although I think there's not going to be anything in them that's not going to be shown in the testimony and referred to in the briefs. It's up to Counsel, I leave it to Counsel. Sometimes they want them made part of the record and most of the time they don't care. What's your wishes?

MR. SLOCOMBE: It makes no difference to us, Your Honor.

MS. WHATLEY: We're certainly –

[7] THE COURT: All right.

Then we'll leave it out. We will not make them part of the record. Now, I have indicated that I have read the memoranda. I think I know what's involved in the case and have indicated what I think the problems are. If your side wants to make an opening statement they're welcome to do so. Mr. Slocombe?

MR. SLOCOMBE: Your Honor, I don't think it's necessary to say anything by way of opening other than as Your Honor's correctly stated we intend to show in the testimony this afternoon, a little bit about the background of the negotiations and specifically, that at a negotiating session which was held on March 6, 1979, NL presented Mr. Clark with the choice between all-stock deal on the part of cash, part-stock deal, that that was a real and

serious offer, that he accepted one of those two choices, the part-stock, part-cash deal.

Beyond that we don't—

THE COURT: Well, let me ask you a question. Let me ask you a question, Mr. Slocombe. Suppose you didn't have this background? Suppose you just had the deal period as reflected in the agreement? Wouldn't you still be arguing for a long-time capital gain?

[8] MR. SLOCOMBE: We would, Your Honor, but think it is—

THE COURT: In other words, this is an an alternative position or buttressing position. If you have to get—if the background is important you think the background's in your favor.

MR. SLOCOMBE: That's correct.

THE COURT: Ms. Whatley?

MS. WHATLEY: Your Honor, the parties agree on the basic facts of what occurred here. You had the sole shareholder of a small corporation agreeing to poor triangular merger whereby his small corporation would be acquired by the larger corporation for stock and cash. It is Respondent's position that this Court should be guided by the analysis of the 5th Circuit in the Shimberg case. The facts of the Shimberg case are virtually identical to this case. We believe that the facts of Wright case and of McDonald are very different from the situation that was present both in Shimberg and in this case.

THE COURT: Well, I think that's probably true that they can be distinguished but if I understand Respondent's position correctly, it comes down that whenever you have a sole shareholder that goes out and trades his stock for stock and cash, [9] stock in a widely held, if not publicly held corporation and ends up with from what was 100 percent to a one percent interest, it doesn't really make any difference. The cash that he pulls out is the dividend.

MS. WHATLEY: Your Honor, it would be our position under the Shimberg analysis that where—

THE COURT: Doesn't that come close to the automatic dividend rule which Respondent, himself, has said he doesn't follow me.

MS. WHATLEY: I think were you have a pro rata distribution, Your Honor, of cash, whether it is pro rata to a single shareholder because he has only one shareholder or pro rata on all shareholders, and you have a small company that has accumulated undistributed earnings and profits, that you must test and determine whether that cash is really a disguised attempt to bail out what would have been dividend income under capital gain treatment. That is the context of this case. We do not have a situation like the Wright situation.

THE COURT: What would you do if the cash wasn't equivalent, wasn't enough, the cash that the acquired corporation was—let's take a figure. The taxpayer gets $10,000 in cash plus stock of the [10] acquiring corporation and the earnings and profits—and the cash, forget the earnings and profits. Let's assume the earnings and profits in the acquired corporation are equal to $10,000 but the balance sheet shows that at the date of the transfer the acquired corporation only had $1,000 in cash. Are you—would you come out the same way?

MS. WHATLEY: Yes, Your Honor—

THE COURT: You say that they have been deemed, they should have—you should treat this as though taxpayer turned in a sufficient amount of stock of the acquired corporation prior to the transfer to pull out enough assets, regardless of the character of the assets, that are equal to the earnings and profits of the acquired corporation. Is that the Respondent's position?

MS. WHATLEY: That is the analysis that was used in Shimberg.

THE COURT: Okay.

I just wanted to understand. Well, the 5th Circuit may be God to some people but not necessarily to this Court. I don't know how I'm going to come out. I think you've got a real sticky wicket here but I'm bothered by the interplay and if you do it—what you're, in effect, saying is there is no way that a [11] sole shareholder can have a merger with another company and get anything other than stock or securities. Let's put it that way, and avoid doing that trick.

MS. WHATLEY: Your Honor, I would modify that slightly in terms of if the four factors that were present in the Shimberg case are present, which would mean that the mergers between unrelated companies—

THE COURT: Well, if you have related companies I think you've got a whole new ballgame. You may be on stronger grounds with related companies than with unrelated companies. I'm talking about an unrelated company. It seems to me that you're right back, at least in the sole shareholder area or in any case where there's no matter how many shareholders in the acquired corporation, there's a pro rata payment of cash as well as stock, you're, in effect, saying got an automatic dividend.

MS. WHATLEY: I realize that it's a difficult question, Your Honor, but it is our position that the 5th Circuit's analysis is the correct analysis on the facts of the case.

THE COURT: In other words, you're blessing Shimberg for, in effect, abrogating what was the prior [12] position in Revenue rulings about the automatic dividend rule. It's all right.

If that's your position, fine. I just wanted to be sure I understood. All right.

Thank you very much.

MS. WHATLEY: Thank you, Your Honor.

THE COURT: Mr. Slocombe, call your first witness.

MR. SLOCOMBE: Your Honor, the first witness will be Ilan Kaufthal.

Thereupon,

ILAN KAUFTHAL

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

THE CLERK: You may be seated. Please state your name and address.

THE WITNESS: My name is Ilan Kaufthal. I reside at 376 Eaton Street in Englewood, New Jersey.

THE CLERK: Would you please spell your name, please?

THE WITNESS: First name is I-L-A-N. Last name is K-A-U-F-T-H-A-L.

DIRECT EXAMINATION

BY MR. SLOCOMBE:

Q Mr. Kaufthal, are you presently employed by [13] NL industries?

A Yes.

Q And what is your present position with them?

A I'm Vice President of Finance.

Q How long have you been employed by NL?

A 14 years.

Q During 1978 and 1979 what was your position with NL?

A I was then director of mergers and acquisitions and the assistant treasurer.

Q And in your capacity as Director of Mergers and Acquisitions what were your duties?

A I was responsible for identifying prospective acquisitions for carrying out negotiations, leading to the consummation of those acquisitions for explaining to the

Board of Directors and senior management, the rationale behind the desire to acquire those companies, and I also had those same responsibilities on divestitures within NL Industries.

Q And in that connection were you personally involved in the acquisition of Basin Surveys by NL?

A Yes. I was.

Q What was the nature of your involvement?

A I was brought in when our McCullough Division expressed an interest in acquiring Basin [14] Surveys to sit down Mr. Clark and Mr. Wallace and attempt to reach an agreement on that acquisition and again, at the same time, put together with the division the rationale and justification to our senior management as to why we wanted to make that transaction.

Q Very briefly for the record, could you identify what the McCullough Division is?

A Yes. The McCullough Division is the division, was and is a division of NL that's involved in the case hole and open hole logging business.

Q From whom did you get your instructions during these negotiations?

A From two individuals, Mr. Vincent McClean, who was then Executive Vice President of Administration for NL, and from Mr. Ray C. Adam, who was chairman, chief executive and president of the company.

Q And very briefly why was NL interested in Basin?

A Well, we thought that Basin would compliment McCullough's activities by giving the McCullough Division an open hole logging capability which it did not have at that point, and it was also a geographic compliment.

[17] Q Did NL or Mr. Clark initiate the negotiations about acquisition of Basin Surveys?

A My recollection is that we approached Mr. Clark through our McCullough operations and initiated the interest in the company.

Q And do you know when NL first approached Clark to begin those discussions?

A I can't recall exactly but it would have been somewhere in the 1978, second half of '78 based on the chronology of when the transaction finally took place and the discussions we had in the early part of '79.

Q Now, were your personally involved in the initial discussions?

A Not in the very first discussion but as I say I got involved after some discussions had taken place between our division and Mr. Clark.

Q And that would have been later on in 1978?

A Yes. Either later in '78 or very early '79.

Q And at the time your first became involved, what did Mr. Clark want in exchange for his basin Survey stock?

A My recollection is that we were talking about a $10 million proposition, is the way I recall the McCullough Division stating the situation to us.

[16] Q And did NL agree to that price?

A No.

Q Why not?

A We thought it was too high.

Q Did you have a negotiating meeting with Mr. Clark in early March of 1979?

A Yes. We did.

Q Where did that meeting take place?

A In our offices in New York, in the NL offices in New York.

A And who was present at the meeting?

A Myself, Vince McClean, Mr. Clark and Mr. Wallace.

Q And what was the purpose of that meeting?

A The purpose of the meeting was to try to arrive at a final agreement between the parties as to what the purchase price would be for the company and a form of the purchase price.

Q In the course of that meeting did you make a new offer to Mr. Clark?

A Yes. We did.

Q What were the terms of that offer?

A We basically told Don that we would either give him 425,000 shares of NL common stock, or give him $3.25 million and 300,000 shares of NL.

[17] Q Did you discuss that offer with anyone at NL before you made it?

A We discussed it with Mr. Adam and again with Mr. McClean. The three of us discussed that. Yes.

Q And that discussion was by telephone or face-to-face?

A It was face-to-face.

Q The offer was made orally or in writing?

A It was made orally.

THE COURT: Excuse me. May I ask a question? If I understand the figures correctly, the $10 million that Mr. Clark originally wanted ended up being eight and one-half?

THE WITNESS: It ended—

THE COURT: 425,000 shares that—

THE WITNESS: —that's the number, yes, based on about a $20 stock price which I recall of the—at that time.

BY MR. SLOCOMBE:

Q When you made this offer to Mr. Clark did you know in advance which, if either, of the alternatives he would accept?

A No.

Q Was NL prepared to go forward with the transaction on the basis of whichever of the two [18] alternatives Clark might accept?

A Yes. We were.

Q Both of the alternatives involved receipt by Mr. Clark of NL stock. Were you offering to give him stock which was freely transferrable or would there have been some restrictions on transfer?

A No. There would have been some restrictions.

Q Would it be correct to say that under the terms of the alternative offer Mr. Clark had a choice of receiving—

MS. WHATLEY: Objection, Your Honor.

THE COURT: Why?

MS. WHATLEY: That's a leading question.

THE COURT: Shall we let him finish the question before we say whether it's leading or not? Go ahead, Mr. Slocombe.

BY MR. SLOCOMBE.

Q Would it be correct to say that under the terms of the alternative offer Mr. Clark had a choice of getting $325 million in cash or an additional 125,000 shares of NL stock?

A $325 million cash?

Q Wish he had. $3.25 million in cash, or an additional 125,000 shares of NL stock.

[19] A That's correct.

THE COURT: I don't see—the agreement speaks for itself. If he wants to say what he thinks the agreement says, I don't see any harm in it.

BY MR. SLOCOMBE.

Q If my mathematics is correct that works out to $26 a share. How did that $26 per share compare with the stock exchange price of NL stock at that time?

A Well, my recollection, Mr. Slocombe, is that we were trading in approximately $20 a share at the time this negotiation took place.

Q Why was NL willing, in effect, to give Clark more in cash than the market value of the NL stock he was being offered?

A Well, NL was—

THE COURT: Yes, Ms. Whatley?

MS. WHATLEY: Your Honor, I would just like to clarify whether my continuing objection on grounds of relevancy.

THE COURT: You have a continuing objection of all the testimony of all the Petitioner's witnesses.

MS. WHATLEY: Thank you, Your Honor.

THE WITNESS: NL felt very strongly at that [20] time, this was early '79, the oil embargo had occurred a couple of years earlier, the business was doing well, the Natural Gas Policy Act had been passed which was going to encourage drilling for natural gas in our opinion. Just generally the atmosphere of the industry made us believe, including some knowledge we had obviously of our own businesses and where they were headed, that NL was going to be doing very well over the next few years and that the stock price of NL would increase in value. We frankly preferred to have less shares outstanding and to give less shares away if we could do that.

BY MR. SLOCOMBE.

Q When you made the offer did you believe there was a real chance that Mr. Clark would accept the all-stock alternative?

A Yes.

Q To go back to the meeting, what did Mr. Clark do after you made the offer, the alternative offer, to him?

A Well, my recollection is that he asked McClean and I for some time to talk to Mr. Wallace and we left the room and waited for him to tell us he wanted us to come back in so he could tell us his reaction.

[21] Q And approximately how long was that period when you were out of the room?

A I don't recall for sure, a half an hour, not a very lengthy time period.

Q And what happened when you re-entered the conference room?

A Mr. Clark and Wallace indicated that they would accept the offer that included cash and stock.

Q Are you aware of any correspondence or any other written document that was given to Mr. Clark or Mr. Wallace which set forth the terms of the alternative offer in writing for which you made orally to Mr. Clark on March 6th?

A No, sir.

Q Are you aware of any such document that would be an internal NL memorandum or record?

A Not describing that negotiation.

Q In 1978 and 1979 was NL engaged in acquiring or negotiating to acquire other business besides Basin Surveys?

A Yes, sir.

Q Approximately how many such potential acquisitions were in consideration?

A I would say probably a half a dozen.

Q Relative to these other acquisitions, did [22] you consider the Basin Surveys acquisition to be a major one?

A No, sir.

Q Based on your experienced at NL, would it be unusual in an acquisition like the Basin case for there to be no written record either internal or given to the other side evidencing these offers that were made by NL?

A Well, it would not be unusual not to have a written record in a transaction of this size going out to the offeree.

Q Briefly, why is that such negotiations were conducted and be authorized most unorderly?

A Well, first of all, the Chairman of the company at that time, Mr. Adams, very much believed in an informal, unstructured, environment, and we operated that way as a company. Many, many of our discussions related to acquisitions of this nature took place verbally between myself and Mr. McClean.

As far as our communication with Mr. Clark was concerned, we believed at that time, that other companies were interested in Mr. Clark's company. We believed that it was harmful for NL to have an offer a formal offer spelled out on paper transmitted to the offerr which he could take, if he wish, and attempt to [23] have someone else bid a better price. We preferred to have that left verbally and not on a piece of paper. We didn't see any advantage of having it spelled out on a piece of paper.

Q Had you at any point in the previous stages of negotiation given Mr. Clark or Mr. Wallace a piece of paper reflecting NL's negotiating position?

A There was one piece of paper which we discussed with them which was labelled "Discussion Draft." I believe that Mrs. Whatley looked at that and asked me to bring a copy, which I did. And that was a piece of paper that had spelled out on it, a transaction which involved convertible preferreds and some other terms incident to that, but that was the only piece of paper that I recall or have seen that related to that two alternatives, to the deal that we finally did.

Q Now, what happens after the part stock-part cash offer was accepted?

A We basically moved ahead to try to consumate the acquisition as rapidly as possible.

Q And did that include the drafting of formal documents?

A Yes, sir. I was involved in coordinating all of that, drafting of the documents and all the [24] other incident features that related to it.

Q And those documents reflected only the agreement which was actually agreed?

A Yes, sir.

Q Did NL, in effect, transfer to Clark 300,000 shares of NL stock and $3.25 million in cash in connection with the merger?

A Yes, sir.

Q And from what source did NL obtain that $3.25 million in cash?

A From internal funds.

Q And after it became a subsidiary of NL did Basin Surveys reimburse NL for all or any part of that $3.25 million in cash?

A No, sir. We didn't.

MR. SLOCOMBE: No further questions.

THE COURT: Ms. Whatley?

CROSS-EXAMINATION

BY MS. WHATLEY:

Q Thank you, Your Honor.

Mr. Kaufthal, did NL Industries initially make a cash offer to Mr. Clark?

A I don't recall ever having made a cash offer to him.

Q Are you aware of whether the McCullough [25] Division personnel may have made made an initial cash offer or talked in terms of a cash acquisition with Mr. Clark?

A Ms. Whatley, I'm not and I might add that it would have been highly unusual for a division to discuss or negotiate in any form with a respective offeree. Their strict instructions were that they were simply to understand

what the company wanted for selling out and then to get the New York office involved which is, I believe, the way it happened here.

THE COURT: Let the record show that Ms. Whatley's questioning Petitioner's witnesses does not in any way, undermine the validity of her objection.

BY MS. WHATLEY:

Q Thank you, Your Honor.

Mr. Kaufhal, you referred to a discussion draft on direct examination and you stated that that discussion draft was given to Mr. Clark at one point during the discussion. Is that correct?

A When you say given, I reviewed with him. I believe I never, in fact, formally gave him a copy of it. I can't recall for certain but the purpose of it was to discuss the concept which never went very far.

Q And the concept was for an eight percent [26] convertible preferred with a ten-year maturity date. Is that correct?

A Yes.

Q And the conversion terms would be that it would be initially convertible into NL common stock as $30 a share?

MR. SLOCOMBE: Your Honor?

THE COURT: Yeah?

MR. SLOCOMBE: Would it be appropriate to ask that the document be introduced so that it can be—the whole text of whatever it says can be reflected in the record?

THE COURT: What about it, Ms, Whatley?

MS. WHATLEY: Your Honor, I have no problems with offering it as an exhibit if Petitioner's counsel is indicating that they will stipulate to it as an exhibit.

THE COURT: Do you stipulate to it?

MR. SLOCOMBE: I'd need to look at it first but I think so.

THE COURT: You asked him about a discussion draft. I assume you would have seen this.

MR. SLOCOMBE: This is the document Mr. Kaufthal brought with him pursuant to the subpoena.

THE COURT: Why don't we have it stipulated [27] as Exhibit—what is it?

MS. WHATLEY: I have this marked as Exhibit P.

THE CLERK: Respondent's Exhibit P marked for identification.

(The document referred to was marked for identification as Respondent's Exhibit P.)

THE COURT: Respondent's Exhibit P is received in evidence and made part of the record in the case.

(The document referred to, having been previously marked for identification as Respondent's Exhibit P was received in evidence.)

BY MS. WHATLEY:

Q And you stated that these terms for the convertible preferred were discussed with Mr. Clark at one point in the negotiation?

A Yes.

Q NL Industries did not issue more than 300,000 shares of common stock to Mr. Clark, did it?

A No. I don't believe. I don't believe it did.

[28] MS. WHATLEY: Your Honor, I have no additional questions of this witness.

THE COURT: All right.

Do you have any further questions on redirect, Mr. Slocombe?

REDIRECT EXAMINATION

BY MR. SLOCOMBE:

Q Just one.

Were the terms of the discussion draft—when you presented the discussion draft did that meet sufficient interest with Mr. Clark that the idea was pursued?

A No. I'm glad you asked that question. I think it's important to note that that was, in fact, our concept of a transaction which might make sense to NL Industries, which I reviewed and discussed with Mr. Clark and Mr. Wallace as an example of the kind of instrument that we could put together specifically again to have NL, in effect, give away it's common stock upon conversion at a higher price than it was then trading for. It did not meet with any kind of interest and it was then trading for. It did not meet with any kind of interest and it was abandoned very early on because we felt it was just not going to become realistically something that they would be interested in receiving for their company.

[29] MR. SLOCOMBE: Thank you. No further questions.

THE COURT: Ms. Whatley?

Thank you very much.

THE WITNESS: Thank you, sir.

THE COURT: Call your next witness, Mr. Slocombe

MR. SLOCOMBE: Petitioners would call Mr. Robert J. Wallace.

Thereupon,

ROBERT J. WALLACE

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

THE CLERK: Please be seated and state your name for the record.

THE WITNESS: My name is Robert J. Wallace, W-A-L-L-A-C-E. I reside at 1 Christopher Lane, Buckhannon, B-U-C-K-H-A-N-N-O-N, West Virginia.

DIRECT EXAMINATION

BY MR. DAVIDSON:

Q Mr. Wallace, what is your present occupation?

A I'm an attorney.

Q And are you involved with a lawfirm, corporation?

[30] A I live sort of a dual life. I have a private law practice in that I am a partner of the lawfirm of Colton and Wallace at Buckhannon. I also serve as an in-house counsel for an oil and gas drilling corporation at Buckhannon called Union Drilling.

Q Have you held any position in the West Virgina Bar?

A I'm past president of the West Virginia State Bar—

MS. WHATLEY: Your Honor, are his offices with the Bar—

THE COURT: I agree. This is not an expert. He's a lawyer. I'm willing to accept him. Let me also suggest to you—

MR. DAVIDSON: Mr. Davidson.

THE COURT: Mr. Davidson, I'm trying to get Daniels straight. Mr. Wallace was in the room so except to the extent that you feel you have to you can ask him just—he heard the previous witness testify. I don't know whether you intend to take him through the same routine.

MR. DAVIDSON: It was our intention to cover the negotiations in light of Respondent's reluctance to stipulate—

[31] THE COURT: No. I understand that. But he sat in this room and heard the previous witness testify. Why don't you just ask him have you heard the previous witness testify? Unless you think there are differences in his knowledge that has to be brought out, I'm just suggesting a way to telescope this. I don't—

MR. DAVIDSON: I know. I appreciate that, Your Honor.

Your Honor, to telescope it, I would just ask him about the events at the meeting that we're focused on.

THE COURT: All right.

Ms. Whatley, do you want Mr. Davidson to take him through each step all over again?

MS. WHATLEY: Your Honor, I don't believe that will be necessary.

THE COURT: Okay. Fine.

BY MR. DAVIDSON:

Q Mr. Wallace, you were involved in the—were you involved in the negotiations between Mr. Clark and representatives at NL?

A Yes, sir.

Q And what was the nature of your involvement?

A I represented Mr. Clark in Basin Surveys in [32] the negotiation.

Q And were you present at a negotiating meeting between Mr. Clark and NL on March 6, 1979?

A That was one of a number of meetings that I attended.

Q Who was present at that meeting?

A Mr. Clark and myself, Mr. Ilan Kaufthal and Mr. Benson McClean.

Q Where was that meeting held?

A At the NL corporate headquarters in New York City.

Q At that meeting did Mr. Kaufthal make an offer to Mr. Clark?

A Yes.

Q What was the nature of that offer?

A The offer that he made was exactly the one that he testified to earlier. He offered an alternative. I say he, I mean NL.

Q Uh-huh.

A They gave us a choice of 425,000 shares of NL stock or 300,000 shares and $3.25 million.

Q After Mr. Kaufthal made the offer you just described, what did Mr. Clark do?

A We asked that Mr. McClean and Mr. Kaufthal leave the room and at that point we thoroughly [33] discussed the offer. We were a bit surprised by the alternative offer of all stock in that we had initially sought an all stock transaction and NL had indicated to us that they were not willing to do an all stock transaction so that the negotiations prior to that point over a period of time, generally focused in on different ways that we might be able to do the deal without actually doing an all stock deal.

Q What was the all stock transaction that Mr. Clark originally sought?

A 500,000 shares of the NL stock.

Q At the March 6, 1979 meeting did Mr. Clark respond to this alternative offer he was given?

A Yes. After we thoroughly digested the offer and discussed that there is ramifications of it we, at that point, decided that we would take the part/cash, cash/part stock offer.

Q Did NL keep the all stock alternative open to Clark for a period of time following March 6 so that he might give the matter further thought?

A Yes. We were told that even after that meeting if we wanted to change our minds and go into—take the all stock offer, that we'd still have the opportunity to do so.

Q Now, did Mr. Clark subsequently confirm to [34] Mr. Kaufthal his acceptance of the cash and stock alternative?

A Yes.

Q And approximately when did that occur?

A My best recollection, the latter part of March, some meeting, I think March 29th.

Q Now, Mr. Wallace, you indicated that early in the negotiations, Mr. Clark was looking to receive 500,000 shares of NL stock and no cash in exchange for his Basin Surveys?

A That's correct.

Q Yet on March 6 when he was presented with an alternative choice between an all stock and a cash and stock arrangement he chose the cash and stock arrangement. From your discussions with Mr. Clark, do you know why he made that decision?

A In part upon my recommendations. During the course of the negotiations I think our position changed rather substantially on what would be in the best interest as far as Mr. Clark was concerned. First of all, there was a question that Mr. Clark, who was not the rich man but whose livelihood was tied up in his company, if he accepted an entire total of all stock offer he, in my judgment, was running a very substantial risk. If something happened to NL [35] and NL stock, he stood to take a very substantial loss.

Because of that I thought it would be best maybe for Mr. Clark to hedge his bet and take some cash along with the stock. Secondly, there was the question of the fact that the stock would be a registered – not a registered stock but more or less a restricted letter stock, which became clear to us during the course of our discussions, which meant that Mr. Clark would have to hold that stock for a couple of years, basically, before he could realistically do anything with it other than sell it as letter stock which would impair the value of it. That gave me concern.

Thirdly, it was a practicality of the fact that as I indicated, Mr. Clark's whole life was tied up in his company. If, in fact, he didn't get any cash out of the deal he was going to have to wait for a couple of years really before he had any economic realization from the transaction, which

would have meant that this outstanding bills would have remained outstanding, what have you. Those factors plus just pure economics of the situation led us to believe that we would be better off to take the part cash/part stock offer.

[36] Q When Mr. Kaufthal presented Mr. Wallace during the March 6, 1979 meeting did you take notes?

A Yes.

MR. DAVIDSON: Your Honor, I ask that the sheet of yellow legal paper that I have in my hand be marked for identification as Petitioner's Exhibit 1.

THE CLERK: Petitioner's Exhibit 1 marked for identification.

(The document referred to was marked for identification as Petitioner's Exhibit 1.)

MR. DAVIDSON: Your Honor, in order to save time we've decided not to proceed further on this line. I have no further on direct.

THE COURT: That includes those notes?

MR. DAVIDSON: That includes these notes.

THE COURT: All right.

Ms. Whatley:

CROSS-EXAMINATION

BY MS. WHATLEY:

Q Thank you, Your Honor.

Mr. Wallace, were you involved in all of the discussions between Mr. Clark and the representatives of NL Industries?

A The initial contact meeting Mr. Clark had by [37] himself, I was not present. I was involved in all of the other meetings that were held. There were also some telephone conversations, of course, between Mr. Clark and NL representatives that I would have not been a party to.

Q Do you remember anyone at any point in the discussions offering Mr. Clark all cash for Basin Surveys?

A There was—let me put it this way. This thing dragged on over a long period of time. There were a number of different alternatives that were explored. As far as actual offers that were made, they weren't made until that March 6 meeting.

Q Do you remember anyone exploring the alternative of an all cash deal?

A I recollect that we discussed it and the ramifications of it along with three or four other possible approaches.

Q Do you remember the range of an all cash offer?

A Mr. Clark zeroed in on 500,000 shares at the $20 per share equivalency very early in the negotiations and that, basically, was the bottom line that we talked about.

Q Do you remember anyone from NL discussing a [38] cash pay fare in the range of $8.5 to $9 million?

A There was a preferred stock discussion of $7.5 million at one point.

Q In terms of cash?

A There could have been. I really don't recall.

MS. WHATLEY: No further questions, Your Honor.

THE COURT: Thank you very much, Mr. Wallace.

THE WITNESS: Yes, sir.

THE COURT: Call your next witness, Mr. Slocombe.

MR. SLOCOMBE: Your Honor, it has been our intention to call Mr. Clark at this point. I have no desire to burden the record. His testimony will be substantially identical to what you've already heard and I'll be guided by Your Honor's—

THE COURT: Do you want to question Mr. Clark?

MS. WHATLEY: Your Honor, I would have only one question and that would concern whether he had any memory of a cash offer.

THE COURT: Well, do you want to put him on the stand for that purpose? Do you have an [39] objection]

MR. SLOCOMBE: If I put him on the stand I'll ask him a question about the meeting.

THE COURT: Well, you don't have to put him on the stand. He's here in the room. She can call him as her witness if she wants.

MR. SLOCOMBE: Why don't we call him and I'll ask him a couple of questions about the meeting, and she can re-examine him.

THE COURT: Okay.

Thereupon,

DONALD E. CLARK

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

THE CLERK: Please be seated and state your name and address.

THE WITNESS: Donald Eugene Clark, Pennsicola, Florida.

DIRECT EXAMINATION

BY MR. SLOCOMBE:

Q Mr. Clark, did you attend a meeting with representatives at NL on March 6, 1979?

A I did.

Q And that meeting was at NL headquarters in New York and it was attended by Mr. McClean, Mr. [40] Kaufthal, Mr. Wallace and yourself?

A Yes.

Q And at that meeting did Mr. Kaufthal make an offer to you with respect to the acquisition of Basin Surveys?

A He did.

Q And what were the terms of that offer?

A 425,000 shares common stock or 300,000 shares common stock and $3.25 million.

Q And did you consider that offer?

A I did.

Q And approximately how long did you and Mr. Wallace discuss it?

A 20, 30 minutes.

Q And what, at that point Mr. Kaufthal and Mr. McClean came back into the room?

A They did.

Q And what did you say to them?

A We told them that at this time we would accept the part cash and part stock.

MR. SLOCOMBE: No further questions.

THE COURT: Ms. Whatley?

CROSS-EXAMINATION

BY MS. WHATLEY:

Q Mr. Clark, during the roughly one year that [41] the discussions went back and forth between you and various people of NL Industries, do you remember anyone suggesting that NL purchase your company for all cash?

A No, I don't.

MS. WHATLEY: No further questions, Your Honor.

THE COURT: Thank you very much, Mr. Clark.

Mr. Slocombe, do you have any further witnesses?

MR. SLOCOMBE: No. Your Honor.

Ms. Whatley?

MS. WHATLEY: No, Your Honor.

THE COURT: All right.

Before I—please be seated. Before I fix the time for filing briefs, Ms. Whatley, let me throw something out here.

And I haven't looked at the Shimberg case—you may remain seated if you want—

MS. WHATLEY: Thank you, Your Honor.

THE COURT: You don't have to worry about that. But it looks to me—let me put it this way. If Basin Surveys had had $3,250,000 in cash sitting in its coffers or even cash plus investments and even if you wanted to go so far as to include accounts receivable as the equivalent of cash, which is [42] questionable, I might think you have a leg to stand on but here you have a situation where first of all, the purchaser, the acquiring corporation, meaning NL, was putting up a real slug of cash out of its own funds. You just couldn't get that out of Basin Surveys.

And, indeed, if you look at the assets and liabilities even if Mr. Clark had liquidated completely Basin Surveys he wouldn't have gotten all of the earnings and profits out, not after he got through paying the liabilities. And if he liquidated it all, I don't think he would have had a merger. The only you can say he would have gotten all of the earnings and profits out would be to allocate some kind of going concern value to the value on liquidation in order to give him a big capital gain and if he liquidates, he doesn't have a merger.

Yet, that's the only way it seems to me he could have gotten the money and to say that under these circumstances that, boo, maybe I'm being too realistic and too practical but I got problems and you better compare before you jump on Shimberg and I didn't go look because I didn't think about this—this idea didn't come to me except in the last half hour. I have a feeling that she and Shimberg, there was enough cash sitting around in the corporation to [43] cover the cash that Shimberg got. I may be wrong on that, but I think you may have a problem in this area.

Unless you're going to go for the rule that no matter the nature of the assets of the acquired company all you do is

look at the earnings and profits, look at the amount of cash that comes out that the taxpayer gets. It doesn't make any difference where the cash came from or whether there was enough cash in the acquired corporation to cover it, ipso factor, it's a dividend, and that just is a rule of law bothers me.

Anyway, I assume I will be educated on brief. What kind of time do you want for briefs?

MS. WHATLEY: Your Honor, we discussed this prior to the beginning of the trial. Respondent was prepared to have 120 days for the opening brief because Respondent's counsel has a week-long trial with Judge Cohen at the end of June on U.S. Steel. A 90 day brief schedule would create some problems for me. I would prefer 120 days.

THE COURT: Mr. Sloccombe?

MR. SLOCOMBE: We would be prepared to go forward on the basis of 90 days. I understand that Ms. Whatley–

THE COURT: Well, I'm going accommodate Ms. [44] Whatley for 30 days. What do you want for a reply brief?

MS. WHATLEY: 60 days, Your Honor?

THE COURT: All right.

I would think you wouldn't need it but I'll give you 120 days for original briefs and let's take 30 days for reply briefs. I know you've got problems getting it through the national office but the national office clears the original briefs. They ought to clear the reply brief. What's wrong with 30 days?

It's going to interfere with your summer vacation.

MR. SLOCOMBE: Not with 120 days it won't

THE COURT: I will give you 120 and 60 but I don't want any extensions asked for.

MS. WHATLEY: That's fine, Your Honor.

THE COURT: That goes for both sides.

MR. SLOCOMBE: Yes, sir.

THE COURT: All right.

120 days for original briefs and 60 days for – unless you want seriatim briefs.

MS. WHATLEY: That's the first time I changed, Your Honor.

THE COURT: All right. You want to be sure he doesn't have the last word. It that it?

Okay.

120 days for original briefs, 60 days for reply briefs. The clerk will announce the dates.

THE CLERK: August 29, 1984, and reply briefs November 29, 1984.

THE COURT: Thank you very much, It was an Interesting case. I don't know whether my doubts are going to be sustained through the final opinion or not. We shall see. Anything further?

MS. WHATLEY: I believe 60 days–

MR. SLOCOMBE: It would be late in October rather than late in November.

THE COURT: June, July, August. That's right, Kim.

THE CLERK: October.

THE COURT: Thank you very much.

MS. WHATLEY: Thank you, Your Honor.

MR. SLOCOMBE: Thank you, Your Honor.

THE COURT: Off the record. The Court stands recessed until tomorrow morning.

THE CLERK: All rise.

(Thereupon, proceedings were concluded.)

UNITED STATES TAX COURT

Docket No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION

Pursuant to the opinion of the Court filed on February 6, 1986, as amended by the Court's Order dated March 7, 1986, and incorporating the facts recited in the petitioners' computation as the findings of the Court, it is:

ORDERED AND DECIDED: That there is a deficiency of $14,171 in petitioners' income tax liability for 1979.

/s/ THEODORE TANNENWALD
Theodore Tannenwald
Judge

Entered: SEP. 18, 1986

It is stipulated that the foregoing decision is in accordance with the opinion of the Court and the petitioners' computation, and that the Court may enter this decision.

WILLIAM F. NELSON
Chief Counsel
Internal Revenue Service

By: MELVIN E. LEFKOWITZ/KEW SEP 5, 1986
Melvin E. Lefkowitz Date
District Counsel
422 Universal North Bldg.
1875 Connecticut Ave., N.W.
Washington, DC 20009-5782
(202) 376-0662

/s/ WALTER B. SLOCOMBE
Walter B. Slocombe 9 Sep 86
Caplin & Drysdale, Chartered
Suite 1200
One Thomas Circle
Washington, D.C. 20005

In the Supreme Court of the United States

No. 87-1168

COMMISSIONER OF INTERNAL REVENUE, PETITONER

v.

DONALD E. CLARK, ET UX.

ORDER ALLOWING CERTIORARI. Filed March 7, 1988.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fourth Circuit is granted.

☆ U.S. GOVERNMENT PRINTING OFFICE: 1988—202-037/60807

(5)

Supreme Court, U.S.
FILED
MAY 5 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 87-1168

In the Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

CHARLES FRIED
Solicitor General

WILLIAM S. ROSE, JR.
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

ERNEST J. BROWN
Attorney

Department of Justice
Washington, D.C. 20530
(202) 633-2217

QUESTION PRESENTED

In this case, a relatively small corporation was merged into a subsidiary of a large publicly-owned corporation, and the sole shareholder of the acquired corporation received in return both cash and shares of the stock of the publicly-owned corporation. The question presented is whether that payment of cash had the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2) of the Internal Revenue Code.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutes and regulations involved	2
Statement	2
Summary of argument	7
Argument:	
Respondent's receipt of cash, in addition to NL stock, in exchange for his Basin stock had the effect of the distribution of a dividend within the meaning of Section 356(a)(2) of the Code	10
A. The statutory framework	12
B. The payment of boot in a reorganization on a pro rata basis to the shareholders of the acquired corporation has the effect of the distribution of a dividend	16
C. The substitution of a hypothetical scenario, consisting of a reorganization without boot followed by a partial stock redemption, in place of the actual reorganization involving boot is not the correct method of determining whether the actual boot distribution has the effect of a dividend under Section 356(a)(2)	27
Conclusion	40
Appendix	1a

TABLE OF AUTHORITIES

Cases:

Agway, Inc. v. *United States*, 525 F.2d 1194 (Ct. Cl. 1975)	16
American Mfg. Co. v. *Commissioner*, 55 T.C. 204 (1970)	34, 35
Atlas Tool Co. v. *Commissioner*, 614 F.2d 860 (3d Cir.), cert. denied, 449 U.S. 836 (1980)	34
Ballenger v. *United States*, 301 F.2d 192 (4th Cir. 1962)	16

Cases—Continued: Page

Bradbury v. *Commissioner*, 298 F.2d 111 (1st Cir. 1962) 16
Campbell v. *United States*, 144 F.2d 177 (3d Cir. 1944) ... 22, 23
Commissioner v. *Estate of Bedford*, 325 U.S. 283 (1945) 23, 24, 25
Commissioner v. *Forhan Realty Co.*, 75 F.2d 268 (2d Cir. 1935) 22
Commissioner v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974) 9, 33
Commissioner v. *Owens*, 69 F.2d 597 (5th Cir. 1934) 21, 23
Davant v. *Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967) 34
DeGroff v. *Commissioner*, 444 F.2d 1385 (10th Cir. 1971) 23
Don E. Williams Co. v. *Commissioner*, 429 U.S. 569 (1977) 33
General Housewares Corp. v. *United States*, 615 F.2d 1056 (5th Cir. 1980) 27
Hawkinson v. *Commissioner*, 235 F.2d 747 (2d Cir. 1956) 16, 22, 25, 31
Himmel v. *Commissioner*, 338 F.2d 815 (2d Cir. 1964) ... 16
Idaho Power Co. v. *United States*, 161 F. Supp. 807 (Ct. Cl.), cert. denied, 358 U.S. 832 (1958) 23
King Enterprises, Inc. v. *United States*, 418 F.2d 511 (Ct. Cl. 1969) 22, 25, 31
Lewis v. *Commissioner*, 176 F.2d 646 (1st Cir. 1949) .. 18, 19, 23
Liddon v. *Commissioner*, 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956) 23
Love v. *Commissioner*, 113 F.2d 236 (3d Cir. 1940) 23
Metzger Trust v. *Commissioner*, 693 F.2d 459 (5th Cir. 1982), cert. denied, 463 U.S. 1207 (1983) 16
Paulsen v. *Commissioner*, 469 U.S. 131 (1985) 12, 18
Rose v. *Little Investment Co.*, 86 F.2d 50 (5th Cir. 1936) . 22
Ross v. *United States*, 173 F. Supp. 793 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959) 22, 23, 25, 31-32, 33
Sheldon v. *Commissioner*, 6 T.C. 510 (1946) 22
Shimberg v. *United States*, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) 5, 6, 19, 20, 25, 26, 31, 32
United States v. *Davis*, 397 U.S. 301 (1970) 7, 15, 16, 17, 29, 30

Cases—Continued: Page

United States v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970) 25
United States v. *Wells Fargo Bank*, No. 86-1521 (Mar. 23, 1988) 14
Woodard v. *Commissioner*, 30 B.T.A. 1216 (1934) 22
Woodward v. *Commissioner*, 23 B.T.A. 1259 (1931) 22, 23
Wright v. *United States*, 482 F.2d 600 (8th Cir. 1973) 5, 6, 22, 26, 28, 32

Statutes and regulations:

Act of Mar. 4, 1923, ch. 294, 42 Stat. 1560 13
Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 4(a), 94 Stat. 3401 12
Internal Revenue Code of 1954 (26 U.S.C.):
§ 301 ..... 2, 7, 15, 16, 17, 1a-2a
§ 301(a) 15, 1a
§ 302 ..... *passim*, 2a-4a
§ 302(a) 38, 2a
§ 302(b)(1) 15, 27, 2a
§ 302(b)(2) 5, 27, 28, 2a-3a
§ 302(d) 30
§ 316 ..... 2, 7, 15, 16, 17, 18, 4a-5a
§ 316(a) 18, 4a-5a
§ 317 ..... 2, 5a
§ 354 ..... 2, 13, 5a-6a
§ 354(a)(1) 3, 12, 5a
§ 356 ..... 2, 29, 6a
§ 356(a)(1) 3, 13, 14, 16, 6a
§ 356(a)(2) ..... *passim*, 6a
§ 358 ..... 12, 13
§ 358(a) 38
§ 362 13
§ 362(b) 12
§ 368 ..... 10, 16
§ 368(a)(1) 12
§ 368(a)(1)(A) 3, 12, 13, 21
§ 368(a)(1)(C) 13, 21

Statutes and regulations – Continued: Page

§ 368(a)(1)(D) 23
§ 368(a)(1)(G) 12
§ 368(a)(2)(D) 3, 13
§ 368(b) 13
§ 1001(a) 38
§ 1001(c) 12

Revenue Act of 1921, ch. 136, 42 Stat. 227:
§ 202(c)(2), 42 Stat. 230 12
§ 202(e), 42 Stat. 230-231 13

Revenue Act of 1924, ch. 234, § 203, 43 Stat. 256-258 12

Treas. Reg.:
§ 1.312-11(b) 18
§ 1.356-1 18
§ 1.368-1(b) 18

Miscellaneous:

B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (4th ed. 1979) 18

Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 Tax L. Rev. 437 (1950) 16

Cohen, Surrey, Tarleau, & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 Colum. L. Rev. 1 (1952) 25

Darrell, *The Scope of* Commissioner *v.* Bedford Estate, 24 Taxes 266 (1946) 25

H.R. Conf. Rep. 98-861, 98th Cong., 2d Sess. (1984) 31

H.R. Rep. 179, 68th Cong., 1st Sess. (1924) 14, 20

Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 Tax L. Rev. 297 (1984) 19, 20, 21

Pedrick, *Some Latter Day Developments in the Taxation of Liquidating Distributions*, 50 Mich. L. Rev. 529 (1952) 29

Rev. Rul. 74-515, 1974-2 C.B. 118 25

Rev. Rul. 74-516, 1974-2 C.B. 121 ..... 25, 31

Miscellaneous – Continued: Page

Rev. Rul. 75-83, 1975-1 C.B. 112 31

S. Rep. 398, 68th Cong., 1st Sess. (1924) 14, 20

Samansky, *Taxation of Nonqualifying Property Distributed in Reorganizations*, 31 Case W. Res. 1 (1980) 19, 21, 29

Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965) 25

In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-1168

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 828 F.2d 221. The opinion of the Tax Court (Pet. App. 15a-39a) is reported at 86 T.C. 138.

JURISDICTION

The judgment of the court of appeals (Pet. App. 40a) was entered on September 4, 1987. On November 25, 1987, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including January 2, 1988. On December 17, 1987, the Chief Justice further extended the time for filing a petition for a writ of certiorari to and including January 11, 1988. The petition was filed on that date and was granted on March 7, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 301, 302, 316, 317, 354, and 356 of the Internal Revenue Code of 1954 (26 U.S.C.), as amended, are set forth in the Appendix, *infra*, 1a-6a.

STATEMENT

1. For some 15 years prior to April 1979, respondent Donald E. Clark[1] had been the president of Basin Surveys, Inc. (Basin), a West Virginia corporation that furnished radiation, nuclear, and electronic open-hole logging services to the petroleum industry, and he then owned all of its outstanding 58 shares of stock. N.L. Industries, Inc. (NL) was then a publicly-held New Jersey corporation engaged in manufacturing and supplying petroleum equipment and services, chemicals and metals. NL had outstanding approximately 32,533,000 shares of a single class of common stock and 500,000 shares of preferred stock. That stock was publicly traded on the New York and Pacific Stock Exchanges. N.L. Acquisition Corp. (NLAC) was a wholly owned subsidiary of NL. Pet. App. 16a; J.A. 26-27.

In 1978, NL initiated discussions with respondent concerning the possible acquisition of Basin. After several months of negotiations, in March 1979 NL offered respondent alternative terms for the acquisition of Basin: (1) 425,000 shares of NL common stock without cash; or (2) 300,000 shares of NL common stock and $3,250,000 in cash. Respondent decided in favor of the latter alternative. Pet. App. 16a.[2]

[1] Respondent Peggy S. Clark is a party herein only because she filed a joint federal income tax return for the calendar year 1979 with her husband, respondent Donald E. Clark. References to "respondent" in the singular will be to Donald E. Clark.

[2] In the Tax Court, respondent's attorney testified (and it was agreed that, if called, respondent would testify to the same effect (J.A. 60)) that, at the meeting at which NL made its alternative offers, respondent had requested the NL representatives to leave the room so that he could discuss the alternatives with his attorney. In that discussion, the factors that led to a tentative choice of the latter alternative were that respondent's "whole livelihood was tied up in his company," and that an all-stock deal would involve the risk of serious loss if something happened to NL. Moreover, the stock of NL that would be received would not be registered stock, but would be restricted letter stock, which would mean, under Securities and Exchange Commission rules, that respondent would have to hold the stock for two years before he could sell it and realize full value. And, in view of respondent's complete involvement with his company, that, in turn, would have meant that he could not immediately pay his outstanding bills. J.A. 56-59.

On April 3, 1979, an agreement and plan of merger was executed by Basin, NLAC, NL, and respondent. The plan provided that, on April 18, 1979, Basin would merge with and into NLAC, which would change its name to Basin Surveys, Inc., and that respondent would receive, with respect to each of the 58 shares of Basin that he owned, 5,172.4137 shares of NL common stock and $56,034.482 cash. The merger took place as planned. Respondent received a total of 300,000 shares of NL common stock and $3,250,000 in cash, and he entered into an employment agreement with the new Basin Surveys, Inc., for three years and an agreement not to compete for five years. Respondent and the Internal Revenue Service (IRS) stipulated that the merger of Basin into NLAC was effected pursuant to, and qualified as, a reorganization as defined in Section 368(a)(1)(A) and (a)(2)(D) of the Internal Revenue Code.[3] Pet. App. 16a-17a; J.A. 27-28.

2. Section 356(a)(1) of the Code provides that, if cash or other property (commonly known as "boot") is received in the course of what would otherwise be a tax-free, stock-for-stock reorganization (see I.R.C. § 354(a)(1)), the re-

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

cipient must recognize his gain on the transaction up to the value of that cash or other property received. Accordingly, in their joint federal income tax return for 1979, respondents reported the cash received in the merger as taxable gain.[4] They characterized this amount as long-term capital gain. Section 356(a)(2) of the Code, however, requires that, if the exchange "has the effect of the distribution of a dividend," the distributee must treat the amount of the gain as a dividend to the extent of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. Applying this section, the Commissioner on audit determined that $2,319,611 of the reported gain (which was the amount of the accumulated earnings and profits of Basin at the time of the merger (J.A. 29)) should be treated as a dividend. Because that amount would then be taxable as ordinary income, rather than as capital gain, this determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979 (J.A. 11-22).

3. Respondents petitioned for review in the Tax Court, which ruled in their favor in a reviewed decision (Pet. App. 15a-39a). The court viewed the question

[4] The closing price of NL stock on the New York Stock Exchange on April 18, 1979, was $23⅛ per share; on that basis the 300,000 shares received by respondent had a value of $6,937,500. Respondent's cost basis in his 58 shares of Basin stock was $84,515, and he incurred expenses of $25,013 in connection with the merger. J.A. 28. Thus, he realized $10,077,972 in gain on the merger. Pursuant to Section 356(a)(1), respondent was required to recognize this gain only up to the amount of the cash received in the transaction, $3,250,000. Respondents erroneously listed the amount of the gain on their return as $3,195,294, but, in their later computation for entry of decision by the Tax Court, respondents acknowledged that the amount of gain recognized and reported should have been $3,250,000 (see Br. in Opp. 4 n.5). The deficiency found by the Tax Court (see J.A. 66) reflects that acknowledged error.

whether respondents' receipt of cash in the merger had the effect of the distribution of a dividend as turning on a choice between two "judicially articulated tests" set forth in *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973), and *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) (Pet. App. 18a). According to the Tax Court, the *Shimberg* test would treat the cash distribution as if it constituted a redemption of stock in the acquired corporation prior to the merger, and the *Wright* test would treat the cash payment as if it constituted "a distribution by the *acquiring* corporation (NL) in a hypothetical redemption of the shares of NL stock that would have been received if petitioner had accepted stock in lieu of the cash consideration" (Pet. App. 18a (emphasis in original)).

The Tax Court then concluded that it should follow *Wright* and treat the cash payment as part of a hypothetical post-merger redemption of the 125,000 shares of NL stock that respondent declined to accept as part of the exchange for his Basin stock. The court stated that this approach was necessary if the cash payment is to "be viewed and tested within the context of the entire reorganization" (Pet. App. 33a). Because such a redemption would have reduced respondent's hypothetical holdings in NL from 425,000 to 300,000 shares, the cash received on the hypothetical redemption would not have been essentially equivalent to a dividend under the redemption provisions of the Code (see I.R.C. § 302(b)(2)).[5] Under the Tax

[5] Under the "safe harbor" provisions of Section 302(b)(2), cash received upon a "substantially disproportionate redemption" will not be treated as a dividend. The statute defines such a redemption as one in which both the shareholder's percentage interest in voting stock in the corporation following the redemption is less than 80% of what it was before the redemption and he retains less than 50% of the voting power in the corporation following the redemption.

Court's approach, this conclusion that the funds that would have been received in a hypothetical post-merger redemption would not be treated as a dividend meant that the cash received by respondents in the reorganization should not be viewed as having the effect of a dividend either, and therefore respondents were entitled to capital gain treatment upon the reported gain. Pet. App. 34a-35a.

4. The court of appeals affirmed (Pet. App. 1a-14a). Like the Tax Court, the court of appeals approached the case as requiring it to choose between *Wright* and *Shimberg* (see Pet. App. 8a). The court first concluded that the dividend determination is to be made by importing into the reorganization context the principles applicable to the redemption of stock of a single corporation under Section 302 of the Code (Pet. App. 3a-6a). The court then concluded that the tests of Section 302 should be applied as if there had been a hypothetical redemption after a different reorganization was completed, *i.e.*, as if respondent had received 425,000 shares of NL stock in a stock-for-stock merger and thereafter had received $3,250,000 in a redemption of 125,000 of his NL shares. Under this view, the question whether the cash payment should be treated as a dividend turns on the extent of the reduction in respondent's interest in NL that would be occasioned by the hypothetical redemption of 125,000 shares of NL stock. Pet. App. 7a-11a. The court criticized the *Shimberg* approach, which it characterized as treating the cash payment as being made by the acquired corporation (Pet. App. 10a-14a). The court of appeals stated, inter alia, that this approach failed adequately to consider the "corporate control [respondent] retained after the reorganization was completed" (*id.* at 10a-11a).

SUMMARY OF ARGUMENT

1. The reorganization provisions of the Code establish an exception to the general principle that the entire amount of gain or loss must be recognized upon the sale or exchange of property. The premise of this exception is that transactions that qualify as reorganizations under the Code entail only a readjustment of continuing interests; the reorganized corporation is a continuation of the same enterprise in modified corporate form. One consequence of this premise of continuing interests is that a distribution of cash or other property in the course of the reorganization may operate as a substitute for a distribution of the accumulated earnings and profits of one of the corporations involved in the transaction—a distribution that ordinarily would be accomplished by the declaration of a dividend. Accordingly, Section 356(a)(2) provides that such a "boot" distribution in the course of a reorganization should be treated as a dividend to the extent of accumulated earnings and profits if it has "the effect of the distribution of a dividend."

The basic attribute of a dividend, derived from Sections 301 and 316 of the Code, is a pro rata distribution to shareholders out of corporate earnings and profits. When a distribution is made that is not a formal dividend, "the fundamental test of dividend equivalency" is whether the distribution is proportionate to the shareholders' stock interests (*United States* v. *Davis*, 397 U.S. 301, 306 (1970)). Accordingly, this Court concluded in the context of a pro rata redemption that "Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316" (*id.* at 312), and the same is true of pro rata distributions of boot in the course of a reorganization. A payment of boot made on a pro rata basis to the shareholders of one of the corporations in-

volved in a reorganization (including, as in this case, a corporation wholly owned by one shareholder) thus has all the earmarks of a dividend. Moreover, it clearly has the "effect" of a dividend in that the shareholders are in precisely the same position after a reorganization that includes boot in the amount of retained earnings and profits that they would have been in had the corporation instead declared out those earnings and profits as a dividend before entering into a reorganization without boot. Therefore, a long line of authority has held that a pro rata distribution of boot in the course of a reorganization to the shareholders of the acquired corporation has "the effect of the distribution of a dividend" within the meaning of Section 356(a)(2).

2. The court of appeals erred in holding that whether a boot distribution has "the effect of the distribution of a dividend" must be determined by first recasting the transaction actually entered into by the parties--substituting a pure stock-for-stock reorganization followed by a redemption of some of the shares for cash in the amount of the boot actually received--and then applying to that hypothetical transaction the principles of Section 302 of the Code that govern redemptions. There is no reason generally to import with full effect the principles of Section 302 into the Section 356(a)(2) inquiry; the two provisions address different types of transactions and the reasons that impelled Congress to except certain redemptions from dividend treatment do not necessarily apply in the reorganization context. Cases like this one involving pro rata boot distributions can and should be resolved simply by reference to the terms of Section 356(a)(2) because such distributions have all the earmarks of a dividend.

The court of appeals' hypothetical redemption analysis violates the general principle that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once

having done so, he must accept the tax consequences of his choice." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). The stock-for-stock reorganization hypothesized by the court of appeals is precisely the option that respondent rejected in favor of a transaction involving boot; he decided to reject that option for good reasons of his own (see note 2, *supra*), and there is no reason to permit him to enjoy its tax consequences. The hypothetical redemption scenario also introduces other difficulties into the Section 356(a)(2) analysis. Because the distribution is to be measured against the earnings and profits of the acquired corporation to determine how much of it can be a dividend, the court of appeals' approach imputes to Congress the intent to establish a peculiar mode of analysis under Section 356(a)(2)--the boot is to be viewed as coming from the *acquiring* corporation for purposes of determining whether it has "the effect of the distribution of a dividend," but it is to be viewed as coming from the *acquired* corporation for purposes of comparing it to earnings and profits. Moreover, the court of appeals' approach requires a court to base its decision upon what may be an extremely speculative judgment as to the number of shares that would be redeemed in the hypothetical transaction.

Finally, the hypothetical redemption scenario does not comport with the terms of the statute. Under Section 356(a)(2), a boot payment must be treated as a dividend as long as it has "the effect of the distribution of a dividend." It is clear that the pro rata distribution in this case had the effect of a dividend distribution by Basin. At most, the court of appeals' analysis seeks to demonstrate that the boot payment also had the effect of a different transaction--a hypothetical redemption. But, even if that were true, it would not alter the result under the terms of Section 356(a)(2). In any event, it is not correct to say that the

boot distribution here had the same effect as the hypothetical post-merger redemption analyzed by the court of appeals. If the parties in fact had engaged in the hypothesized transaction, the recognized gain would have been different, as would as the continuing earnings and profits accounts of the surviving corporations and respondent's basis in his NL shares. There is no basis for equating the two transactions for purposes of Section 356(a)(2) analysis.

ARGUMENT

RESPONDENT'S RECEIPT OF CASH, IN ADDITION TO NL STOCK, IN EXCHANGE FOR HIS BASIN STOCK HAD THE EFFECT OF THE DISTRIBUTION OF A DIVIDEND WITHIN THE MEANING OF SECTION 356(A)(2) OF THE CODE

Respondent surrendered all of his shares of Basin stock in a transaction qualifying as a reorganization under Section 368 of the Code. In return, he received both shares of NL stock and cash. The question in this case is whether the cash or "boot" paid to respondent had "the effect of the distribution of a dividend" under Section 356(a)(2) of the Code. A long line of court of appeals decisions has held that a boot distribution made under circumstances parallel to those in this case—*i.e.*, on a pro rata basis to the shareholders of the acquired corporation, in this case to a sole shareholder—is to be treated as a dividend. That conclusion follows directly from the statutory language because the boot distribution closely approximates a dividend, and it has precisely the same effect. To the extent of Basin's undistributed earnings and profits (of which there were more than $2 million at the time of the merger), the payment had all the earmarks of a classic dividend; it was a distribution of cash out of a corporation's earnings and

profits made on a pro rata basis to its shareholders. And respondent was in precisely the same position after the merger that he would have been in had the amount of Basin's accumulated earnings and profits been distributed to him as a formal dividend, rather than as part of the boot received in the reorganization. To the extent of those earnings and profits, therefore, the boot distribution had "the effect of the distribution of a dividend."

The court of appeals, however, rejected this conclusion and the line of authority that supports it. The court did so by recasting the merger transaction into a form different from that entered into by the parties—indeed, into a form that respondent had explicitly rejected in the merger negotiations. The court of appeals ruled that the transaction should be treated as if respondent had received 425,000 shares of NL stock in a tax-free stock-for-stock reorganization and then subsequently had redeemed 125,000 of those shares for $3,250,000 in cash. The court then applied the dividend equivalency rules for redemptions of stock in a single corporation (I.R.C. § 302) to the hypothetical redemption that it had posited. Because application of those rules would not have resulted in dividend treatment for the hypothetical redemption, the court ruled that the boot distribution that actually occurred also should not be treated as a dividend. There is, however, no basis for believing that this hypothetical redemption analysis furthers congressional intent. It should be rejected in favor of a basic application of the terms of Section 356(a)(2), which advances the evident congressional purpose of applying dividend treatment to distributions of retained earnings and profits made in the course of a reorganization when those distributions have the effect of a dividend.

A. *The Statutory Framework*

1. The reorganization provisions of the Code constitute an explicit exception to the general principle that the entire amount of gain or loss is to be recognized upon the sale or exchange of property (see I.R.C. § 1001(c)). As this Court recently explained, the purpose of this exception is "to free from the imposition of an income tax purely 'paper profits or losses' wherein there is no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form" (*Paulsen* v. *Commission*, 469 U.S. 131, 136 (1985) (internal quotation marks omitted)). The reorganization provisions seek to define the transactions in which the continuity of interest is such that it is appropriate to defer recognition of gain or loss.

Although Congress has engaged in substantial modification and refinement over the years, the basic structure of the reorganization provisions dates back to Section 202(c)(2) of the Revenue Act of 1921, ch. 136, 42 Stat. 230, and to the further development of those provisions in Section 203 of the Revenue Act of 1924, ch. 234, 43 Stat. 256-258. The Code has long defined as reorganizations six basic types of corporate transactions (see § 368(a)(1)), including a "merger or consolidation" (§ 368(a)(1)(A)).[6] Section 354(a)(1) of the Code provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities * * * in another corporation a party to the reorganization."[7] Sections 358 and 362(b) reflect the continuity

[6] A seventh type, set forth in Section 368(a)(1)(G), was added in 1980, after the tax year at issue in this case, by Section 4(a) of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3401.

[7] The transaction in this case was a "triangular merger," in which the acquired company (Basin) was merged into a subsidiary (NLAC)

of interest in the reorganized corporation by providing that the basis of the stock or securities received shall be the same as the basis of the stock or securities exchanged, and that the property received by the acquiring corporation shall have the same basis that it had in the hands of the transferor corporation.

Section 354 provides for nonrecognition of gain or loss only when the transaction involves an exchange of stock or securities *solely* for stock or securities. Some forms of reorganization, however, including the "A" (merger or consolidation) and "C" (asset acquisition (see Section 368(a)(1)(C)), permit the receipt of some additional property without losing their status as reorganizations under the Code. These types of transactions are accommodated by Section 356(a)(1), which dates back to Section 202(e) of the Revenue Act of 1921, ch. 136, 42 Stat. 230-231 (as amended by the Act of Mar. 4, 1923, ch. 294, 42 Stat. 1560). That provision qualifies the nonrecognition rule by providing that if, in addition to the property permitted to be received by Section 354, money or other property (commonly known as "boot") is received, "then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." Sections 358 and 362 provide for appropriate adjustments to basis in order to take into account any such recognition of gain.

When it sought to improve the early reorganization provisions in 1924, Congress recognized that some adjustment to this treatment of boot was necessary. The fundamental

of a controlling corporation (NL). Pursuant to Section 368(a)(2)(D), this type of transaction qualifies as an "A" reorganization—*i.e.*, a reorganization under Section 368(a)(1)(A). Pursuant to Section 368(b), the controlling corporation (NL), whose stock was exchanged for respondent's shares of Basin, is identified as a "party to the reorganization."

premise of special reorganization treatment is the assumption of a continuing enterprise, but the predecessor of Section 356(a)(1) allowed a shareholder to receive a distribution from that enterprise without being subject to dividend treatment, even though the distribution could represent retained earnings and profits that ordinarily are taxed as a dividend when distributed to a shareholder. Accordingly, Congress enacted what is now Section 356(a)(2), providing that, when the exchange "has the effect of the distribution of a dividend," boot received in a reorganization is to be treated as a dividend to the extent of the distributee's "ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." [8]

[8] The congressional reports on the 1924 amendment that is now codified as Section 356(a)(2) stated that the change was necessary to prevent "evasions" and gave the following example to demonstrate the need for the change (H.R. Rep. 179, 68th Cong., 1st Sess. 15 (1924); see also S. Rep. 398, 68th Cong., 1st Sess. 16 (1924)):

> Corporation A has capital stock of $100,000 and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.
>
> On the other hand, corporation A may organize corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the stockholders of corporation A in exchange for their stock in corporation A. Under the existing law, the $50,000 distributed with the stock of corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12½ per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the 12½ per cent rate on capital gain.

The "surtax" at that time was the graduated portion of the income tax, which applied to dividends but not to capital gains. See generally *United States* v. *Wells Fargo Bank*, No. 86-1521 (Mar. 23, 1988), slip op. 5.

2. Section 356(a)(2) does not define the phrase "has the effect of the distribution of a dividend," but the Code elsewhere specifically addresses the tax treatment of "dividends." Section 301(a) of the Code provides: "Except as otherwise provided in this chapter, a distribution of property * * * made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." That subsection provides that, for distributions described in subsection (a), "[t]hat portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income." Section 316, in turn, broadly defines a dividend as "any distribution of property made by a corporation to its shareholders * * * out of its earnings and profits," either those earnings and profits accumulated after February 28, 1913, or those of the taxable year. The statute goes on to provide that "[e]xcept as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits." Thus, the rule that emerges from the combination of these provisions is that a distribution of property made by a corporation to its shareholders with respect to its stock is to be included in gross income as a dividend to the extent of the corporation's earnings and profits.

It is established beyond doubt that these statutory provisions require dividend treatment for corporate distributions that are made to shareholders on a pro rata basis, since such distributions are clearly "with respect to [the corporation's] stock," as specified in Section 301. In *United States* v. *Davis*, 397 U.S. 301, 306 (1970), this Court held that a pro rata redemption of stock by the corporation is "essentially equivalent to a dividend" (I.R.C. § 302(b)(1)), regardless of its purpose. The Court described as "the fundamental test of dividend equivalency" whether a distribution to a shareholder is "pro rata or pro-

portionate to his stock interest," and the Court concluded that "Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316 rather than under § 302 [the provision dealing with stock redemptions]" (397 U.S. at 312). In the same vein, the courts of appeals have consistently recognized that the basic earmark of a dividend is a "pro rata distribution out of corporate earnings and profits" (*Hawkinson* v. *Commissioner*, 235 F.2d 747, 751 (2d Cir. 1956)).[9] These principles derived from Sections 301 and 316 provide the basic framework for determining whether a boot distribution "has the effect of the distribution of a dividend" under Section 356(a)(2).

B. The Payment Of Boot In A Reorganization On A Pro Rata Basis To The Shareholders Of The Acquired Corporation Has The Effect Of The Distribution Of A Dividend

The resolution of this case turns entirely on the correct application of Section 356(a)(2) of the Code. It is undisputed that the merger transaction qualified as a reorganization under Section 368 of the Code and therefore that, under Section 356(a)(1), the gain on the exchange must be recognized in the amount of the $3,250,000 in boot received by respondent in the ex-

[9] See also, *e.g.*, *Metzger Trust* v. *Commissioner*, 693 F.2d 459, 462 (5th Cir. 1982), cert. denied, 463 U.S. 1207 (1983); *Agway, Inc.* v. *United States*, 524 F.2d 1194, 1198 (Ct. Cl. 1975) (quoting *Himmel* v. *Commissioner*, 338 F.2d 815, 817 (2d Cir. 1964) (emphasis in original)) (" 'The hallmarks of a dividend, then, are pro rata distributions of earnings and profits *and* no change in basic shareholder relationships.' "); *Ballenger* v. *United States*, 301 F.2d 192, 196-197 (4th Cir. 1962); *Bradbury* v. *Commissioner*, 298 F.2d 111, 116 (1st Cir. 1962) (quoting Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 Tax L. Rev. 437, 476 (1950)) (" 'the most obvious earmark[ ] of a dividend is the pro rata distribution of earnings and profit[s]' [which is] the basic criterion of whether a particular distribution more closely equates a sale or a dividend.").

change. The tax treatment of that amount of gain, however, depends upon whether the exchange "has the effect of the distribution of a dividend" within the meaning of Section 356(a)(2). If it does, then the boot should be treated as a dividend to the extent of Basin's undistributed earnings and profits ($2,319,611) and therefore taxed as ordinary income; if the exchange does not have the effect of a dividend, then the boot should be taxed as capital gain. We submit that the type of distribution that occurred in this case—on a pro rata basis to the shareholders of the acquired corporation—has the "effect of the distribution of a dividend" under Section 356(a)(2).

1. As we have noted, the basic attribute of a dividend is a pro rata distribution to shareholders out of corporate earnings and profits. That is what occurred here. Basin had $2,319,611 in undistributed earnings and profits at the time of the merger. In the course of the merger, that amount (and more) of cash was distributed to respondent, Basin's sole shareholder. Since any distribution to a sole shareholder is, by definition, a pro rata distribution (see *United States* v. *Davis*, 397 U.S. at 307), the payment to respondent in this case was "with respect to [his] stock" (I.R.C. § 301) and had all the earmarks of a dividend.

It is true, of course, that the payment to respondent in this case came from NL and therefore did not formally come out of Basin's earnings and profits. But Section 356(a)(2) does not require that the boot distribution literally constitute a formal dividend under Section 316. As we have seen, Congress recognized that a formal dividend test was inappropriate because boot distributions might not clearly be made by a single corporation, but rather could occur in the course of a reorganization involving more than one corporation. For that very reason, Section 356(a)(2) requires only that the exchange have "the *effect* of the distribution of a dividend" (emphasis added). This

condition is clearly satisfied when a pro rata distribution of boot is made in the course of a transaction that falls within the reorganization provisions of the Code.

The principle underlying the statutory reorganization treatment conferred upon respondent's merger transaction is that the reorganization yields "a continuance of the proprietary interests in the continuing enterprise under modified corporate form" (*Lewis* v. *Commissioner,* 176 F.2d 646, 648 (1st Cir. 1949)). See also *Paulsen* v. *Commissioner,* 469 U.S. at 136; Treas. Reg. § 1.368-1(b) (reorganizations effect "only a readjustment of continuing interest[s] in property under modified corporate forms"). This principle lies "at the heart of the nonrecognition provisions and is the reason why gain or loss, although realized, is not recognized at the time of the exchange." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.01, at 14-4 (4th ed. 1979).

Because respondent's interest in the reorganized corporate entity is thus regarded as a continuation of his interest in Basin, it follows that it should make no difference that the payment to him formally came from NL, rather than Basin. It still should be deemed to have been "made out of earnings and profits to the extent thereof" (I.R.C. § 316(a)).[10] In sum, as the Fifth Circuit stated in connec-

[10] The nonrecognition rules of the reorganization provisions, of course, operate as a limited exception to the broadly applicable dividend provisions of Section 316. The relevant regulations explicitly provide that "[t]he general rule provided in section 316 that every distribution is made out of earnings or profits to the extent thereof * * * does not apply to * * * [t]he distribution, in pursuance of a plan of reorganization, * * * [o]f *stock or securities*" of corporate parties to the reorganization (Treas. Reg. § 1.312-11(b) (emphasis added)). Clearly, however, the rule of Section 316 continues to apply to money or other property distributed pursuant to the plan of reorganization. See Treas. Reg. § 1.356-1.

tion with a boot distribution indistinguishable from the one in this case, "[i]f a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a 'continuance of the proprietary interests in the continuing enterprise under modified corporate form,' it follows that the pro rata distribution of 'boot' to shareholders of one of the participating corporations must certainly have the 'effect of the distribution of a dividend' within the meaning of § 356(a)(2)" (*Shimberg* v. *United States,* 577 F.2d 283, 288 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) (quoting *Lewis* v. *Commissioner,* 176 F.2d at 648)). See also Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2),* 39 Tax L. Rev. 297, 324 (1984) (describing the logic of the above quotation as "unassailable").[11]

Moreover, there can be no doubt that the boot distribution here had the same "effect" that a direct dividend distribution by Basin of its earnings and profits would have had. The distribution of such a dividend would have reduced the value of Basin by the amount of the dividend and accordingly reduced the amount of the boot that NL

[11] If it were not for the nonrecognition treatment accorded by Congress for reorganizations, of course, both the amount of the boot and the rest of the more than $10 million of gain realized upon the Basin-NL transaction would have been recognized and treated as capital gain from the *sale* of a capital asset. But the parties to the merger here sought to have the transaction treated not as a sale, but as a tax-free reorganization, and therefore it is not appropriate to regard the boot as the proceeds of the sale of a capital asset, which would confer a "double benefit of nonrecognition and capital gain" (Samansky, *Taxation of Nonqualifying Property Distributed in Reorganizations,* 31 Case W. Res. 1, 27 (1980)). See generally Kyser, *supra,* 39 Tax L. Rev. at 325-326. The premise of the nonrecognition treatment is the continuing interest of the participating shareholders in the reorganized entity, as opposed to a sale; Section 356(a)(2) recognizes that another consequence of that continuing interest is that boot distributions in the course of the reorganization can have the effect of dividends and should be taxed accordingly.

would have given in exchange for respondent's stock. The post-merger financial situation of both respondent and the reorganized corporation would have been the same, whether the amount of Basin's earnings and profits were distributed to respondent as boot or as a dividend; hence, in the words of the congressional reports accompanying the original version of Section 356(a)(2), the "effect" was "the same as if the corporation had declared out as a dividend its * * * earnings and profits" (H.R. Rep. 179, 68th Cong., 1st Sess. 15 (1924); S. Rep. 398, 68th Cong., 1st Sess. 16 (1924); see note 8, *supra*). See *Shimberg* v. *United States,* 577 F.2d at 288.

More generally, dividend treatment of boot distributions made pro rata to the shareholders of the acquired corporation is logical and comports with the apparent congressional purpose to restrict the use of reorganizations as an avenue to withdraw profits from a corporation without declaring a dividend. As one commentator has noted, "intuition suggests that what is really going on [with such a boot payment] is that the shareholders of the target are making use of their last opportunity to withdraw profits from their corporation before they lose control as a result of dilution by the reorganization" (Kyser, *supra,* 39 Tax L. Rev. at 326). There is nothing unfair or unreasonable about treating such a boot payment as a dividend. The shareholders of the target—respondent alone in this case—are the ones who earned the profits and allowed them to accumulate in the target corporation rather than distributing them as dividends prior to the reorganization. They are also the persons who negotiate the terms of the acquisition with the acquiring corporation, including the extent to which there will be a payment of boot and whether the acquisition will be structured as a tax-free reorganization, rather than a taxable sale. The boot, then, appears to be simply a substitute for the undeclared dividends; the shareholders "realize[ ] some or all of the value from earnings of the transferor corporation at the time of the reorganization rather than realizing it at a prior time" (Samansky, *Taxation of Nonqualifying Property Distributed in Reorganizations,* 31 Case W. Res. 1, 35 (1980)). See generally Kyser, *supra,* 39 Tax L. Rev. at 341-342. Thus, it requires a tortured reading of Section 356(a)(2) to conclude that such a pro rata boot distribution does not have "the effect of the distribution of a dividend."

2. The judicial interpretations of Section 356(a)(2) since its enactment in 1924 strongly support the conclusion that it contemplates dividend treatment for boot that is distributed pro rata to the shareholders of the acquired corporation. A long and consistent line of court of appeals decisions in the wake of the 1924 Act recognized that, where two corporations not previously under common control are unified, either by statutory merger or consolidation (I.R.C. § 368(a)(1)(A)) or by the transfer of substantially all of the assets of one to the other in exchange for voting stock of the latter (I.R.C. § 368(a)(1)(C)), and the shareholders of one or both corporations receive a pro rata payment of boot, that payment has the effect of a dividend and is to be taxed as such. The first case in this line is *Commissioner* v. *Owens,* 69 F.2d 597 (5th Cir. 1934), where two banks merged and the shareholders of the smaller bank received pro rata both stock in the new bank and cash. The court held that "so much of [the cash] as might before consolidating have been declared by their corporation as an ordinary dividend out of its profits is by [the predecessor of Section 356(a)(2)] to be so taxed" (69 F.2d at 598). The court specifically noted (*ibid.*): "It is true that the money was not distributed by the [acquired bank] and thus was not literally a dividend of that bank. But the statute speaks of a distribution which 'has the effect of the distribution of a

dividend.' This pro rata payment to all stockholders of the [acquired bank] * * * certainly has that effect."

Subsequently, several other courts of appeals reached the same conclusion regarding boot received on a pro rata basis. See *King Enterprises, Inc.* v. *United States,* 418 F.2d 511, 521 (Ct. Cl. 1969) ("The distribution on a pro rata basis, entailing no substantially disproportionate change in the continuing equity interests of the Tenco stockholders, constituted a classic example of a transaction having the effect of the distribution of a dividend."); *Hawkinson* v. *Commissioner,* 235 F.2d at 751 ("the distribution had all the earmarks of a taxable dividend, i.e., a pro rata distribution out of corporate earnings and profits"); *Campbell* v. *United States,* 144 F.2d 177, 182 (3d Cir. 1944) ("We [previously] held that when cash was distributed in a reorganization to the stockholders of the predecessor company that part of the amount thus distributed which equalled the accumulated earnings of the predecessor corporation had the effect of a taxable dividend and was accordingly taxable as such."); see also *Ross* v. *United States,* 173 F. Supp. 793, 798 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); *Rose* v. *Little Investment Co.,* 86 F.2d 50 (5th Cir. 1936); *Commissioner* v. *Forhan Realty Co.,* 75 F.2d 268 (2d Cir. 1935); *Sheldon* v. *Commissioner,* 6 T.C. 510 (1946); *Woodard* v. *Commissioner,* 30 B.T.A. 1216, 1229-1230 (1934); *Woodward* v. *Commissioner,* 23 B.T.A. 1259 (1931); but see *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973) (rejecting dividend treatment for distribution to 99% shareholder where there was commonality of ownership in the merging corporations).[12] On the other hand, where the cash payment

[12] All of these cases (except *Wright*), like the present one, involve "A" or "C" reorganizations of corporations not under common control. There are many more cases requiring dividend treatment for boot

was not pro rata to the shareholders of one of the corporations, but rather was made only to holders of preferred stock who did not own any common stock in order to call and retire that preferred stock, the payment was held not to have the effect of a dividend. *Idaho Power Co.* v. *United States,* 161 F. Supp. 807 (Ct. Cl.), cert. denied, 358 U.S. 832 (1958).

This line of cases also repeatedly reaffirmed the conclusion of the court in *Owens* (see 69 F.2d at 598) that it is immaterial which corporation actually pays out the cash to the shareholders. While that may be relevant to whether the payment is *technically* a dividend, it has no bearing on whether the payment has "the effect of the distribution of a dividend." As the Court of Claims stated, "regardless of who physically paid out the money, and regardless of whose name is placed on those earnings, the effect is the same as if the Trust Company [the acquired corporation] had made a distribution out of funds specifically labeled 'Trust Company earnings and profits' " (*Ross* v. *United States,* 173 F. Supp. at 798). See also *Campbell* v. *United States,* 144 F.2d at 182; *Woodward* v. *Commissioner,* 23 B.T.A. at 1262.

This established line of authority was noted approvingly and relied upon by this Court in *Commissioner* v. *Estate of Bedford,* 325 U.S. 283 (1945). That case dealt with a factual situation somewhat different from the one here in that it involved a recapitalization (an "E" reorganization),

received in a "D" reorganization ("a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders * * * is in control of the corporation to which the assets are transferred," I.R.C. § 368(a)(1) (D)). See, *e.g., DeGroff* v. *Commissioner,* 444 F.2d 1385 (10th Cir. 1971); *Liddon* v. *Commissioner,* 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956); *Lewis* v. *Commissioner, supra; Love* v. *Commissioner,* 113 F.2d 236 (3d Cir. 1940).

which is the one form of reorganization that involves a single corporation. The taxpayer estate in *Bedford* was a shareholder of a corporation that had accumulated earnings and profits, but was disabled under state law from declaring dividends. To remedy that situation, the corporation amended its capital structure. In exchange for its 3,000 shares of preferred stock, the estate received 3,500 shares of a lesser preferred, 1,500 shares of common stock, and $45,240 in cash. Invoking the statutory definition of "dividend" in the predecessor of Section 316, the Court concluded that the cash must be regarded as having come out of the corporation's accumulated earnings and hence had the effect of a distribution of a dividend (325 U.S. at 290). The Court buttressed its holding by referring with approval to the existing cases cited above (see pages 21-22, *supra*) that required dividend treatment in the case of reorganizations involving two corporations. The Court stated (325 U.S. at 291): "It has been ruled in a series of cases that where the stock of one corporation was exchanged for the stock of another and cash and then distributed, such distributions out of earnings and profits had the effect of the distribution of a taxable dividend under [the predecessor of Section 356(a)(2)]. * * * We cannot distinguish the two situations and find no implication in the statute restricting [the predecessor of Section 356(a)(2)] to taxation as a dividend only in the case of an exchange of stock and assets of two corporations." [13]

[13] In the course of rejecting an alternative argument made by the estate, the Court made the statement that "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' " (325 U.S. at 292). This statement was read by some as establishing an "automatic dividend rule" that would accord dividend treatment to any cash received on a reorganization, whether pro rata or not – for example, cash distributed to dissenters from a merger who demand appraisal of their stock (see, *e.g.*, *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970)). This "automatic dividend rule" was heavily criticized by the commentators (see, *e.g.*, Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965); Darrell, *The Scope of* Commissioner *v.* Bedford Estate, 24 Taxes 266, 268-275 (1946)). The post-*Bedford* cases in this area have rejected this broad reading of this Court's decision and have concluded that this Court was not attempting to establish a rule that would extend to cases involving a non-pro-rata distribution, which was not involved in *Bedford*. See *Shimberg* v. *United States*, 577 F.2d at 290 & n.19; *King Enterprises, Inc.* v. *United States*, 418 F.2d at 520; *Hawkinson* v. *Commissioner*, 235 F.2d at 750-751; *Ross* v. *United States*, 173 F. Supp. at 797. The IRS has also rejected this broad reading of *Bedford*. See Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121.

This line of court of appeals authority was capped by

The court of appeals here, however, completely misunderstood the nature of the debate over the "automatic dividend rule". The court erroneously described the abandoned reading of *Bedford* as stating "that any pro rata distribution in a reorganization must automatically be treated as a dividend" (Pet. App. 6a) and, in the same vein, it erroneously stated (*id.* at 11a) that the government's contention here "comes close to resurrecting the abandoned automatic dividend rule of *Bedford*." The "abandoned automatic dividend rule" is one that would have required dividend treatment for any distribution, even one that was not pro rata. And the critics of the broad reading of *Bedford* did not question the propriety of dividend treatment for pro rata distributions. See, *e.g.*, Shoulson, *supra*, 20 Tax L. Rev. at 608; Cohen, Surrey, Tarleau, & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 Colum. L. Rev. 1, 48 (1952) ("the possible implication of the *Bedford* decision, that any boot on a reorganization is a dividend, would not be followed, so that boot distributions which are *disproportionate* to common stock holdings would not be regarded as dividends." (footnote omitted; emphasis added)). The longstanding rule for pro rata distributions has not been abandoned; as we have shown, it has been consistently applied by the courts of appeals since 1934 and was approved by this Court in a portion of the *Bedford* opinion that has never been questioned. Because the present case involves a pro rata distribution, the "abandoned automatic dividend rule" (Pet. App. 11a) is not implicated.

Shimberg v. *United States, supra.* As the Tax Court noted below (Pet. App. 27a), the facts of *Shimberg* are essentially indistinguishable from those here. A smaller corporation was there merged into a larger one, and the shareholders of the acquired corporation received shares in the acquiring corporation, plus $625,000 in cash, to be allocated among the shareholders on a pro rata basis. The court of appeals upheld the Commissioner's determination that the boot was taxable as a dividend. The court noted the long line of authority supporting the proposition that pro rata boot distributions have the effect of a dividend (577 F.2d at 288), and it found distinguishable the one decision that diverged from this line, *Wright* v. *United States, supra,* because of the commonality of ownership of the combining corporations there (577 F.2d at 287 (see note 16, *infra*). The court explained the basis for its conclusion as follows (*id.* at 288):

> If a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a "continuance of the proprietary interests in the continuing enterprise under modified corporate form," it follows that the pro rata distribution of "boot" to shareholders of one of the participating corporations must certainly have the "effect of the distribution of a dividend" within the meaning of § 356(a)(2). * * * Moreover, the legislative history of § 356(a)(2)'s predecessor statute makes clear that a distribution that would have been a dividend if made prior to the reorganization is subject to the same treatment when made as part of the transaction.

The court concluded that "[t]he taxpayer should not be able to reap the benefits of capital gain treatment simply because he received his share of the distribution after the merger in the form of a 'boot' rather than before the merger

in the form of a dividend" (577 F.2d at 289). See also *General Housewares Corp.* v. *United States,* 615 F.2d 1056, 1066 (5th Cir. 1980). Thus, a consistent line of decisional law confirms that boot distributed on a pro rata basis to the shareholders of the acquired corporation has the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2).

C. The Substitution Of A Hypothetical Scenario, Consisting Of A Reorganization Without Boot Followed By A Partial Stock Redemption, In Place Of The Actual Reorganization Involving Boot Is Not The Correct Method Of Determining Whether The Actual Boot Distribution Has The Effect Of A Dividend Under Section 356(a)(2)

The court of appeals in this case did not directly examine the merger transaction entered into by the parties to determine whether the exchange involving boot had the effect of the distribution of a dividend. Instead, the court first addressed the abstract question whether the determination of dividend treatment under Section 356(a)(2) must be made by applying the principles set forth in Section 302 of the Code. That Section governs the tax treatment of redemptions of stock in a single corporation. It provides, inter alia, that a redemption will be treated as an exchange if it "is not substantially equivalent to a dividend" (§ 302(b)(1)); and it establishes "safe harbors" under which a redemption that causes a specified reduction in the shareholder's percentage interest in the corporation is automatically insulated from being found to be substantially equivalent to a dividend (§ 302(b)(2); see note 5, *supra*). Largely because of the similarity in the language of the two sections with respect to dividend treatment, the court of appeals concluded that Section 302 must be applied to determine when a boot distribution has "the effect of the distribution of a dividend" under Section 356(a)(2) (see Pet. App. 5a).

Having concluded that Section 302 principles must be applied, the court of appeals then needed to find a redemption to which to apply them, since the merger transaction entered into by the parties did not involve a redemption. Following the path indicated by *Wright* v. *United States, supra,* the court recast the merger transaction to create a hypothetical redemption. The court constructed a scenario based upon a pure stock-for-stock reorganization in which respondent received 425,000 shares of NL stock – which was precisely the option offered to and rejected by respondent in the merger negotiations – followed by a post-merger redemption of 125,000 of those shares in exchange for the $3,250,000 that had been distributed to respondent as boot in the actual transaction (Pet. App. 7a-11a). Because that hypothetical redemption, standing alone, would have satisfied the "safe harbor" of Section 302(b)(2) by reducing respondent's interest in NL from 1.3% to 0.92%, it would not have been taxed as a dividend (see Pet. App. 7a, 34a). In the court of appeals' view, this conclusion concerning the hypothetical redemption necessarily meant that the boot distribution did not have "the effect of the distribution of a dividend" under Section 356(a)(2). The court of appeals' analysis is flawed in several respects.

1. Most fundamentally, the court erred in beginning its analysis by focusing on the abstract question whether Section 302 principles govern, and the rest of its analysis compounds this error. Obviously, the starting point of the analysis must be the terms of Section 356(a)(2), the section that Congress made applicable to boot distributions. If that section appears inadequate to its task in a particular case, it may be appropriate to look elsewhere in the Code for guidance, such as to Section 302 (see note 15, *infra*). But in the situation presented here, a pro rata distribution of boot to the shareholders of the acquired corporation,

Section 356(a)(2) itself clearly indicates that the boot should be treated as a dividend to the extent of accumulated earnings and profits. See point B, *supra.* There was thus no reason for the court of appeals to look to Section 302.

Second, the court of appeals further erred in concluding that Section 302 should be imported with full effect into the reorganization context to determine when boot should be treated as a dividend under Section 356(a)(2). It is true, of course, that there is some relationship between the two sections; both provisions address the question whether a particular transaction should be treated as a dividend, and they use similar language. Nevertheless, there are also significant differences. Most notably, Section 302 is addressed to a transaction between a shareholder and a single corporation, while Section 356 deals with a reorganization transaction frequently involving two, often unrelated, corporations. Section 302's allowance of exchange treatment for certain redemptions is an exception to the general rule that corporate distributions are taxable as dividends (see *United States* v. *Davis,* 397 U.S. at 304). There is no reason to assume that the reasons that impelled Congress to create that exception should apply equally in the reorganization context so that every nuance and detail of Section 302 should be applied in interpreting Section 356(a)(2). See generally Samansky, *supra,* 31 Case W. Res. at 17-20, 29.[14] Thus, there is no logical reason why the

---

[14] Indeed, to the extent the redemption provisions were designed to provide an opportunity for shareholders of closely held corporations to sell their stock back to the corporation for capital gain where there is no outside market for the stock (see, *e.g.*, Pedrick, *Some Latter Day Developments in the Taxation of Liquidating Distributions,* 50 Mich. L. Rev. 529, 530 (1952)), the purpose of the redemption provisions has little relevance to the reorganization context. In the latter context, the shareholder does not need a special opportunity provided by Congress to sell his shares of stock; the reorganization demonstrates that there

characterization of boot distributions should necessarily be governed by Section 302 principles.

At all events, under a proper analysis the theoretical question whether Section 302 redemption principles should be applied to determine the effect of boot distributions under Section 356(a)(2) is of no practical significance in a case like this one, where the distribution is made on a pro rata basis to the shareholders of one of the corporations. A pro rata redemption of stock is "essentially equivalent to a dividend" and therefore taxable as a dividend under Section 302(d). That is clear from *United States* v. *Davis, supra,* where this Court upheld dividend treatment for a pro rata redemption, noting that whether or not the distribution is pro rata is "the fundamental test of dividend equivalency" (397 U.S. at 306). The Court's conclusion in *Davis* that "Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316 rather than under § 302" (*id.* at 312) applies to all pro rata distributions of cash—whether as a formal dividend, in exchange for the redemption of stock, or in the course of a reorganization. Thus, whether Section 356(a)(2) is applied directly to the pro rata boot distribution in this case, or, alternatively, whether reference is made to Section 302 redemption principles, should not affect the ultimate conclusion that the pro rata distribution has "the effect of the distribution of a dividend" under Section 356(a)(2).[15]

---

is a market for them. Instead, he has deliberately chosen to transfer his stock by means of a tax-free reorganization, which is the antithesis, for tax purposes, of a sale, and he should not be relieved from the consequences of that choice.

[15] This is not to say that Section 302 principles can never have any relevance to the Section 356(a)(2) analysis. On the contrary, in the context of a non-pro-rata boot distribution, which does not have all the earmarks of a dividend, reference to Section 302 may provide

The authorities relied upon by the courts below confirm that, in the context of a pro rata boot distribution, the abstract inquiry into whether Section 302 principles apply is merely a theoretical diversion that provides no basis for failing to treat the boot as a dividend. The courts below based their incorporation of Section 302 into Section 356(a)(2) analysis primarily upon the assertion that "the courts have consistently held that the sections should be read *in pari materia*" (Pet. App. 5a, 23a). The courts below (and respondents (see Br. in Opp. 8)) clearly erred in reading the cases they cite as justifying the substitution of a hypothetical redemption analysis for the longstanding rule that pro rata boot distributions have the effect of a dividend. Each of the cases relied upon, except one, is a case that held that a pro rata boot distribution *should* be treated as a dividend.[16] As the court explained in *Ross* v.

---

helpful guidance in approaching the Section 356(a)(2) question. Thus, the court in *Shimberg* noted that it did not totally reject the relevance of redemption principles in the context of a reorganization (577 F.2d at 290). By the same token, the Commissioner has stated that the principles developed under Section 302 for determining dividend equivalency may "in appropriate cases" serve as "useful guidelines for purposes of applying section 356(a)(2)" (Rev. Rul. 74-516, 1974-2 C.B. at 122). See also Rev. Rul. 75-83, 1975-1 C.B. 112; H.R. Conf. Rep. 98-861, 98th Cong., 2d Sess. 845 (1984). But these principles become useful only in the context of a non-pro-rata distribution. There is no need to refer to Section 302 when the distribution is pro rata (although looking to Section 302 would produce the same result (see Rev. Rul. 75-83, *supra*)); the payment is clearly a dividend. Therefore, this case presents no occasion to consider to what extent the detailed formulations of Section 302 should be applicable in the case of a non-pro-rata boot distribution (see, *e.g.*, Pet. App. 12a) or whether, in such circumstances, a different result could obtain under Section 356(a)(2) than would be indicated by Section 302.

[16] See *Shimberg* v. *United States, supra; King Enterprises, Inc.* v. *United States,* 418 F.2d at 521 ("little doubt" that pro rata boot distribution should be treated as a dividend because it is a "classic example of a transaction having the effect of the distribution of a dividend"); *Hawkinson* v. *Commissioner,* 235 F.2d at 751 ("the distribu-

United States, 173 F. Supp. at 797, all that is meant in these cases by reading the two statutes *in pari materia* is that in both situations it is necessary to look at "all the facts and circumstances surrounding the distribution."

---

tion had all the earmarks of a taxable dividend, *i.e.*, a pro rata distribution out of corporate earnings and profits"); *Ross* v. *United States, supra.*

Wright v. *United States, supra,* does lend a measure of support to the decision below since it looked to a hypothetical post-reorganization redemption to determine whether a boot distribution was a dividend. *Wright,* however, arose in a very different factual context and provides little guidance for the instant case. In *Wright,* the pre-reorganization landscape was composed of three corporations owned largely by the same two persons, but in different proportions. These two major shareholders sought to merge two of the corporations to produce a new corporation that would have the same relative ownership percentages as the third corporation. Because of the differing ownership percentages in the original corporations and the differing sizes of those corporations, however, this result could not be achieved by means of a pure stock-for-stock reorganization and therefore the transaction contained a component of boot issued by the new corporation to the majority shareholder. Stressing that "[t]he corporations involved did not exist separately but were owned and controlled by the same shareholders" (482 F.2d at 607), the court of appeals concluded that the transaction should be analyzed as if the amount of the boot had been distributed by the new corporation in a redemption of stock hypothetically received by the majority shareholder in a reorganization not involving boot. Whatever the merit of that conclusion in *Wright,* it should have little bearing here. As the Fifth Circuit noted in *Shimberg,* the "commonality of ownership" of the merging corporations appeared to have played a large part in the Eighth Circuit's decision in *Wright* to recast the transaction as a redemption of stock in a single corporation; *Wright* did not purport to deal with a situation in which previously separate and independent corporations were involved in a reorganization (see 577 F.2d at 287). Accordingly, regardless of whether *Wright* was correctly decided on its facts, cases like *Shimberg* and the instant case "present[ ] radically different facts and call[ ] for correspondingly different analysis" (577 F.2d at 287).

These cases clearly stand for the proposition that, whether or not Section 302 principles are invoked, the result of this inquiry into the "facts and circumstances" must result in dividend treatment when the boot distribution is made on a pro rata basis to the shareholders of the acquired corporation.[17]

2. In addition to the theoretical weaknesses of the court of appeals' general importation of Section 302 principles into the reorganization context, there are several more specific difficulties with the court's hypothetical post-reorganization redemption analysis. First and foremost, the court of appeals' approach runs directly contrary to the general principle that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.,* 417 U.S. 134, 149 (1974). See also *Don E. Williams Co.* v. *Commissioner,* 429 U.S. 569, 579-580 (1977). The conflict with this principle is particularly stark in this case because the court of appeals not only has failed to hold respondent to the tax consequences of the transaction that he chose, it has given him the tax consequences of an option that was offered to him by NL, and that he deliberately rejected for sound reasons of his own. Respondent presumably acted prudently and according to

---

[17] The court in *Ross* noted that a particular focus of this inquiry should be into whether the declaration of a dividend "would have accomplished the same result" as the boot distribution. 173 F.Supp. at 798. That inquiry strongly confirms that dividend treatment is appropriate here. As the record plainly shows, the result of the boot distribution in this case was to allow respondent to withdraw in the form of cash some of the fruits of his labors in Basin, rather than to have all of them tied up in the future of NL in the form of stock (see J.A. 58-59). Such a withdrawal is precisely the purpose of an ordinary dividend distribution.

his best judgment in deciding to take cash and stock upon the merger of his corporation into NLAC, rather than committing substantially all of his resources to a large corporation in which he would be a minority shareholder (see note 2, *supra*). The court below erred in relieving him of the tax consequences of that choice and instead giving him the tax consequences of the very option that he declined.[18]

The hypothetical post-reorganization redemption analysis also creates practical difficulties in the application of Section 356(a)(2). A boot distribution is taxable as a dividend if it has "the effect of the distribution of a dividend," but only to the extent of the distributee's "ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." It is generally recognized that, at least in the case of a reorganization involving two unrelated corporations like that in this case, the corporation against whose earnings and profits the boot distribution must be measured is the acquired corporation, *i.e.*, the corporation whose shareholders are the recipients of the distribution. See, *e.g.*, *Atlas Tool Co.* v. *Commissioner,* 614 F.2d 860, 868 (3d Cir. 1980), cert. denied, 449 U.S. 836 (1980); *American Mfg. Co.* v. *Commissioner,* 55 T.C. 204, 230-231 (1970); cf. *Davant* v. *Commissioner,* 366 F.2d 874, 887-890 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967) (holding that earnings and profits of both corporations can be examined where there was commonality of ownership). That conclu-

[18] Moreover, it is an unusual feature of this case that the record shows that respondent was offered the option of a pure stock-for-stock reorganization. In the typical case, the hypothetical redemption approach takes a court down a road that may never have even been a possibility. There is generally no basis for assuming that a corporation that acquires another in a reorganization involving boot would necessarily have been willing to issue a greater number of shares in order to make a pure stock-for-stock acquisition.

sion is plainly the most sensible reading of the statute. The background of Section 356(a)(2) suggests that it was passed because "Congress was concerned with a bailout of the earnings and profits of the transferor corporation" (*American Mfg. Co.* v. *Commissioner,* 55 T.C. at 230). Moreover, it is difficult to conceive of a shareholder's having a "ratable share" of the earnings and profits of a corporation in which he held no interest prior to the reorganization.[19] Indeed, the parties stipulated in this case that the amount of the dividend was to be measured against the earnings and profits of Basin, and the courts below did not dispute the correctness of this interpretation (see Pet. App. 8a, 31a).

Thus, the approach of the court below is not consistent in identifying the source of the distribution. It contemplates that the boot distribution be viewed as having been made by the *acquiring* corporation (or, in this case, by its parent, NL) in a hypothetical stock redemption for purposes of determining whether it has the effect of a dividend under Section 356(a)(2), but then it contemplates that the distribution be viewed as having been made by the *acquired* corporation for purposes of determining whether it exceeds the shareholders' ratable share of earnings and profits. There is no reason to impute to Congress an intent to establish such a perverse approach to the basic Section 356(a)(2) determination whether a particular boot distribution should be taxed as a dividend.

[19] In addition, a rule measuring the dividend against the earnings and profits of the acquiring corporation would completely undermine the statutory purpose in some situations. For example, here, if NL had had no accumulated earnings and profits, respondent would escape dividend treatment even if it were agreed that the boot distribution had "the effect of the distribution of a dividend," despite the fact that he had accumulated more than $2 million in earnings and profits in Basin prior to the reorganization.

The hypothetical redemption approach also unnecessarily introduces an additional speculative inquiry into the Section 356(a)(2) analysis. This case is an unusual one in that respondent was offered a choice between two different transactions—a pure stock-for-stock reorganization or one involving boot. Hence, it was relatively easy to construct a hypothetical redemption scenario; it was based on the stock-for-stock option that respondent rejected.[20] But in cases that lack this unusual aspect the hypothetical redemption scenario may require considerable speculation and guesswork. The court of appeals' approach requires a court to determine how many shares would have been exchanged if the reorganization had not involved boot, but instead had been purely stock-for-stock. That determination is critical because the application of the Section 302 "safe harbor" turns on the number of shares that hypothetically would have been received instead of the boot and then redeemed. Determining that number of hypothetical shares can require a difficult and complex inquiry. It involves problems not only of valuing the stock in market terms but also assessing the extent to which the valuation is affected by shifting control, factors that become particularly elusive in the case of closely-held corporations.[21]

---

[20] Even on these facts, the hypothetical redemption analysis involves some speculation. The court of appeals' analysis assumes that respondent would have redeemed 125,000 shares for $3,250,000, apparently based on a price of $26 per share. Had he redeemed that number of shares at the market price on the date of the reorganization, $23⅛ per share (see J.A. 28), he would have received only $2,890,625 upon the redemption.

[21] The imprecision inherent in making this speculative determination is significant here because of the "either-or" nature of the inquiry. In many tax controversies involving a valuation problem, a small variation in valuing property will yield a correspondingly small variation in tax consequences. Here, however, a small variation in the number of shares assigned to the hypothetical redemption can change the resolution of the ultimate issue—whether the entire boot distribution should be treated as having the effect of a dividend.

3. Finally, the court of appeals' hypothetical redemption approach fails to comport with the terms of the statute. As we have shown, the boot distribution in this case had "the effect of the distribution of a dividend" by Basin. The court of appeals never disputes that conclusion. Instead, it chooses to analogize the boot distribution to another transaction, the hypothetical stock-for-stock reorganization followed by a partial redemption. The most that can fairly be said for the court of appeals' suggested analogy is that it attempts to show that the boot distribution might also have the effect of a transaction that would not be a dividend. But, of course, that is not the test that is set forth in Section 356(a)(2). The statute says that a boot distribution that has "the effect of the distribution of a dividend" should be treated as a dividend to the extent of earnings and profits; if that condition is satisfied, there is no statutory basis for deviating from that treatment simply because the distribution also has the effect of a different kind of transaction that would not qualify as a dividend.

In any event, it is not correct to say that the boot distribution here has the effect of the redemption hypothesized by the court of appeals. There is, of course, a superficial similarity between the two transactions in that respondent ends up, before taxes, with the same amount of cash and stock at the end of both. But there are also major differences between the two transactions with respect to the basic tax accounts that are generated, and these differences vitiate any suggestion that the hypo-

thetical redemption can be equated with the boot distribution.

First, the basis of each of the NL shares received by respondent in the reorganization is different in the two transactions. The total basis of those shares is transferred from respondent's basis in the Basin stock he gave in exchange (I.R.C. § 358(a)), and that total basis must be allocated over the total number of shares received. Thus, the basis of each individual share obviously would be different depending upon whether the total basis is allocated over the 300,000 shares received in the actual merger or over the 425,000 shares that would have been received in the transaction hypothesized by the court of appeals.[22] Second, because the gain recognized on a redemption that is not essentially equivalent to a dividend is reduced by the basis of the redeemed shares (I.R.C. §§ 302(a), 1001(a)), the gain recognized in the hypothetical transaction would have been different from the $3,250,000 that respondent acknowledged in the Tax Court had to be recognized on the actual transaction involving boot.[23]

---

[22] On the facts of the actual transaction here, respondent's basis in each of the 300,000 shares he received was $0.3651. Had he received 425,000 shares as hypothesized by the court of appeals, his basis in each share would have been $0.2577.

[23] Because respondent's basis in his Basin shares was so low, this difference in the amount of gain under the two transactions is relatively small in this case ($3,217,787.50 vs. $3,250,000). But the difference could equally as well be quite significant under another set of facts. For example, suppose respondent's basis in his Basin shares had been $4,250,000. Under the hypothetical scenario of the court of appeals, each of the 425,000 NL shares received by respondent in the exchange would then have had a basis of $10. When he redeemed 125,000 of those shares for $3,250,000, the resulting gain would be only $2,000,000. Applying Section 356(a)(1) to the actual reorganization, however, would still yield a taxable gain of $3,250,000.

Another difference between the two transactions is the effect on the earnings and profits accounts. In the actual transaction, the earnings and profits available for distribution as a dividend were Basin's $2,319,611 in accumulated earnings and profits. The gain recognized upon the boot distribution would have been applied against that account. That reflects the basic theory of Section 356(a)(2)—that the shareholders of the corporation who receive a pro rata distribution of boot are withdrawing earnings and profits from the reorganization, subject to the limitations of the amount of their recognized gain and ratable share of earnings and profits. If respondent had chosen the redemption option, on the other hand, the gain would have been applied against and reduced the earnings and profits of NL (a figure that is not in the record here and that, in any event, bears no relation to Basin's or respondent's history). Basin's earnings and profits would have remained intact and been carried over into NLAC, the subsidiary. Thus, the effect on the continuing earnings and profits accounts would be substantially different under the two transactions.

In sum, it cannot be said that the boot distribution that actually occurred here had the same effect as a hypothetical redemption following a pure stock-for-stock reorganization. It remains true, however, that the pro rata boot distribution did have the same effect as a dividend distribution by Basin. Accordingly, Section 356(a)(2) requires that the boot be treated as a dividend to the extent of Basin's undistributed earnings and profits.

CONCLUSION

The judgment of the court of appeals should be reversed.
Respectfully submitted.

CHARLES FRIED
Solicitor General
WILLIAM S. ROSE, JR.
Assistant Attorney General
LAWRENCE G. WALLACE
Deputy Solicitor General
ALAN I. HOROWITZ
Assistant to the Solicitor General
ERNEST J. BROWN
Attorney

MAY 1988

APPENDIX

The Internal Revenue Code of 1954 (26 U.S.C.), as amended, provides in pertinent part:

SEC. 301. DISTRIBUTIONS OF PROPERTY

(a) *In general*

Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount taxable*

In the case of a distribution to which subsection (a) applies –

(1) *Amount constituting dividend*

That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) *Amount applied against basis*

That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) *Amount in excess of basis*

(A) *In general*

Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) *Distributions out of increase in value accrued before March 1, 1913*

That portion of the distribution which is not a dividend, to the extent that it exceeds the ad-

justed basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

* * * * *

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK

(a) *General rule*

If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions treated as exchanges*

(1) *Redemptions not equivalent to dividends*

Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock*

(A) *In general*

Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation*

This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions*

For purposes of this paragraph, the distribution is substantially disproportionate if –

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of –

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions*

This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) *Termination of shareholder's interest*

Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) *Redemption from noncorporate shareholder in partial liquidation*

Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

(5) Application of paragraphs

In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

* * * * *

SEC. 316. DIVIDEND DEFINED

(a) *General rule*

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

SEC. 317. OTHER DEFINITIONS

(a) *Property*

For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) *Redemption of stock*

For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS

(a) *General rule*

(1) *In general*

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(3) *Cross references*

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (2)(B) applies), see section 356.

* * * * *

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION

(a) *Gain on exchanges*

(1) *Recognition of gain*

If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend*

If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1988—202-037/60425

Supreme Court, U.S.
FILED
JUN 20 1988
JOSEPH F. SPANIOL, JR.
CLERK

(6)

No. 87-1166

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

DONALD E. CLARK AND PEGGY S. CLARK,
Respondents.

On Writ of Certiorari to the
United States Court of Appeals
for the Fourth Circuit

BRIEF FOR THE RESPONDENTS

---

*WALTER B. SLOCOMBE
DANIEL S. ROSENBAUM
CAPLIN & DRYSDALE, Chartered
One Thomas Circle, N.W.
Washington, D.C. 20005
(202) 862-5000

June 1988

*Counsel of Record

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8380

51 pp

QUESTION PRESENTED

When Mr. Clark's company was acquired, by a publicly held company, in a tax-free reorganization, Mr. Clark received 300,000 shares of common stock and chose to receive cash instead of 125,000 additional shares of the acquiring company's stock. The question presented is whether, under section 356(a)(2) of the Internal Revenue Code, the cash Mr. Clark received in lieu of additional stock should have been taxed as a capital gain or as a dividend.

TABLE OF CONTENTS

	Page
STATEMENT	1
SUMMARY OF ARGUMENT	4
ARGUMENT	7
I. The courts below correctly determined that the exchange in which Mr. Clark received cash from NL did not have the effect of a dividend.	7
A. The test of a dividend is effect on post-payment ownership.	9
1. There is no dividend when there is a "meaningful reduction" in ownership interest.	9
2. "Meaningful reduction" must be measured with reference to reorganized, continuing enterprise.	9
a. A reorganization results in a continuing enterprise with continuing ownership interest.	10
b. The character of taxable boot depends on the effect of its distribution as part of the reorganization exchange.	11
c. The effect of a boot distribution must be measured by the effect of the exchange on continuing ownership interests.	12
3. The step transaction doctrine requires applying the dividend equivalency test at the surviving corporation level.	14
4. The economic substance and factual record of the present transaction strongly support measuring dividend equivalency by the exchange's effect on ownership in the surviving corporation.	16

B. The courts below properly looked to section 302 in applying the dividend equivalency test at the surviving corporation level.	18
1. Section 302(b) is an appropriate guide because it is concerned with the same issues as section 356(a)(2).	18
2. The section 302 analysis employed by the court of appeals has been widely accepted.	19
3. The technical objections petitioner advances for rejecting section 302 are unsound.	21
C. The approach of the courts below has received wide-spread approval.	23
II. The petitioner's hypothesis of a pre-reorganization dividend was properly rejected.	24
A. Petitioner's isolated view is unrealistic.	24
B. Petitioner improperly equates Mr. Clark's receipt of cash with a dividend effect.	27
C. The distribution was not pro rata on a realistic view.	29
D. Petitioner's approach is subject to manipulation and abuse.	29
E. The legislative history of section 356(a)(2) does not support the petitioner's position.	33
F. The decisions of this court and of other courts of appeals do not compel—or indeed support—petitioner's position.	35
1. *Bedford*	35
2. Court of appeals cases	36
3. *Wright* and *Shimberg*	38
a. The *Wright* case	39
b. The *Shimberg* case	40
CONCLUSION	43

TABLE OF AUTHORITIES

CASES:	Page
Commissioner v. Court Holding Co., 324 U.S. 331 (1945)	6,15
Commissioner v. Estate of Bedord, 325 U.S. 283 (1945)	7,34,35,36
Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974)	17
Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934)	36
General Housewares Corp. v. United States, 615 F.2d 1056 (5th Cir. 1980)	38,42
Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956)	19,37
King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969)	19,22,36,37
Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949)	11
Lorillard v. Pons, 434 U.S. 575 (1978)	21
McDonald v. Commissioner, 52 T.C. 82 (1969)	37
Mills et al v. Commissioner, 331 F.2d 321 (5th Cir. 1964)	38
Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938)	15
Paulsen v. Commissioner, 469 U.S. 131 (1985)	5,10,11
Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959)	19,37
Sellers v. United States, 615 F.2d 1066 (5th Cir. 1980)	38
Shimberg v. United States, 415 F. Supp. 832 (M.D. Fla. 1976), *rev'd*, 577 F.2d 283 (5th Cir 1978)	41
Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978)	7,36,38,42

Table of Authorities Continued

	Page
Slatin v. Stanford Research Institute, 590 F.2d 1292 (4th Cir. 1979)	21
Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951)	10
Stout v. Hancock, 146 F.2d 741 (4th Cir. 1944), *cert. denied*, 325 U.S. 850 (1945)	21
United States v. Davis, 397 U.S. 301 (1970)	5,9,13
Wright v. United States, 482 F.2d 600 (8th Cir. 1973)	5,8,13,19,20 *passim*
Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954)	15,26,31
STATUTES:	
26 U.S.C. § 243	31
26 U.S.C. § 302	6,8,14,18,19
26 U.S.C. § 302(b)(1)	18,39
26 U.S.C. § 302(b)(2)	4,15,18,30
26 U.S.C. § 304(b)(1)	22
26 U.S.C. § 304(b)(2)(A)	22
26 U.S.C. § 318	20
26 U.S.C. § 354(a)(1)	11
26 U.S.C. § 356	5,6,19,22,33
26 U.S.C. § 356(a)(1)	3,5,12,22
26 U.S.C. § 356(a)(2)	3,5,6,7,8 *passim*
26 U.S.C. § 368(a)(1)(A)	3,10,39,40
26 U.S.C. § 368(a)(2)(D)	3
26 U.S.C. § 368(c)(2)(D)	10
26 U.S.C. § 1001(c)	11
RULES AND REGULATIONS:	
Rev. Proc. 77-37, 1977-2 C.B. 568	27

Table of Authorities Continued

	Page
Rev. Rul. 56-220, 1956-1 C.B. 191	35
Rev. Rul. 66-365, 1966-2 C.B. 116	38
Rev. Rul. 74-515, 1974-2 C.B. 118	19,36
Rev. Rul. 75-83, 1975-1 C.B. 112	19,20
Rev. Rul. 75-360, 1975-2 C.B. 110	15
Rev. Rul. 75-447, 1975-2 C.B. 113	15
Rev. Rul. 76-364, 1976-2 C.B. 91	14
Rev. Rul. 76-385, 1976-C C.B. 92	14,33
Rev. Rul. 84-114, 1984-2 C.B. 90	19,32
Rev. Rul. 85-106, 1985-2 C.B. 116	28
Treas. Reg. § 1.368-1(b)	10

LEGISLATIVE MATERIALS:

H. R. Rep. No. 861, 98th Cong., 2d Sess. (1984)	20
H. R. Rep No. 179, 68th Cong., 1st Sess. (1924)	34,35
Joint Committee on Taxation, *Tax Reform Proposals in Connection with Committee on Finance Markup* (JCS 8-86) (1986)	23
Reform of Corporate Taxation: Hearing Before the Committee on Finance United States Senate, 98th Cong., 1st Sess. (1983) (Statement of Ronald A. Pearlman)	23
S. Rep. No. 398, 68th Cong., 1st Sess. (1924)	34
Staff of Senate Committee on Finance, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations* (S. Prt. 98-95, 1983)	23
Staff of Senate Committee on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47, 1985)	23

Table of Authorities Continued

	Page
OTHER:	
ABA Legislative Recommendation 1983-8 (approved by ABA House of Delegates at 1984 Midyear Meeting)	23
Priv. Ltr. Rul. 8431003 (April 19, 1984)	31
Gen. Couns. Mem. 39290 (Sept. 27, 1984)	31
B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, (5th ed. 1987)	22
Darrel, *The Scope of Commissioner v. Bedford's Estate*, 24 Taxes 266 (1946)	35
Fleming, *Reforming the Tax Treatment of Reorganization Boot*, 10 J. Corp. Tax'n 99 (1983)	23
Golub, *"Boot" in Reorganization—The Dividend Equivalency Test of Section 356(a)(2)*, 58 Taxes 904 (1980)	23
Hurley, *Capital Gain Possibilities for Boot in Acquisitive Reorgs Lessened by Shimberg Case*, 50 J. of Tax'n 334 (1979)	23
Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 Tax L. Rev. 297 (1984)	32
Levin, Adess, & McGaffey, *Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency*, 30 Tax Lawyer 287 (1976)	23,31,32
Note, *Boot Distributions in Acquisitive Reorganizations: The Wright-Shimberg Controversy*, 59 S. Cal. L. Rev. 1295 (1980)	31
Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965)	35
Tax Court Decision Could Ruin Risk Arb Biz, Investment Dealers' Dig. (February 17, 1986)	31

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-1168

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

DONALD E. CLARK AND PEGGY S. CLARK

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

---

BRIEF FOR THE RESPONDENTS

STATEMENT

Donald Clark, the respondent,[1] was the sole shareholder of Basin Surveys, Inc. ("Basin"), a West Virginia corporation engaged in the business of providing technical services to the petroleum industry. J.A. 26, 33. In 1978, N.L. Industries ("NL"), a publicly held company with extensive petroleum service operations, initiated negotiations with Mr. Clark over the possible acquisition of Basin.

In the final negotiating session, in March 1979, NL offered Mr. Clark alternative forms of consideration in con-

---

[1] Mr. Clark's wife, Peggy S. Clark, is a party solely because she filed a joint return with her husband for the year in question.

nection with the proposed acquisition of Basin by merger: Mr. Clark had a choice of receiving (1) 425,000 shares of NL common stock, or (2) 300,000 shares of NL common stock and, instead of the additional 125,000 shares, $3.25 million in cash. Pet. App. 2a, 6a. After considering the alternative proposals, Mr. Clark decided to accept the offer which provided him with cash in lieu of the additional shares of stock.[2] J.A. 57. In April 1979, the acquisition was effected through a merger of Basin into a newly formed subsidiary of NL and, as a step in the merger, Mr. Clark received the agreed-upon consideration. Pet. App. 17a.

As a result of Mr. Clark's acceptance of the combined stock and cash offer, the total number of NL common shares outstanding increased to approximately 32,833,000 shares, and Mr. Clark's stockholdings represented approximately 0.92 percent of that total. If Mr. Clark had accepted the all-stock offer of 425,000 shares, the total number of NL common shares outstanding would have increased to approximately 32,958,000 shares, and Mr. Clark's stockholdings would have represented approximately 1.3 percent of that total. Pet. App. 16a. Mr. Clark's 300,000 share ownership of NL after the transaction was 70.6 percent of the 425,000 shares he would have owned had he taken the all-stock offer.

---

[2] In the Tax Court, Mr. Clark's attorney, who participated in the negotiations, testified that Mr. Clark originally sought NL stock as the sole consideration for his Basin stock. J.A. 57. Also at trial, the NL negotiator testified that NL was prepared to go forward with the transaction on the basis of either alternative; that it did not know which offer Mr. Clark would accept; that its preference was to pay Mr. Clark a portion of the consideration in cash as a means of reducing the number of shares of NL stock that would be outstanding after the acquisition; and that the amount of cash offered to Mr. Clark was based on NL's determination of the value of the additional 125,000 shares that it would have had to issue to Mr. Clark in the all-stock proposal. J.A. 46-48. This testimony was accepted as true by the Tax Court. Pet. App., 37a.

The transaction qualified as a "reorganization" under section 368(a)(1)(A) and (a)(2)(D) of the Internal Revenue Code of 1954.[3] Pet. App. 16a-17a. Under section 356(a)(1), Mr. Clark was required to pay tax on the $3.25 million cash or "boot" payment to the extent of his gain on the transaction with NL. Since Mr. Clark's gain (after taking into account the cash and market value of the NL stock he received in exchange for his Basin stock) exceeded the amount of cash received, Mr. Clark reported the entire cash payment as gain, taxable at long term capital gain rates under section 356(a)(2).[4] On audit, the IRS determined that the cash received by Mr. Clark had "the effect of a distribution of a dividend" under section 356(a)(2) and was, therefore, taxable as a dividend.[5] Because dividends are taxable at ordinary income rates, while, in 1979, capital gains were taxed at only 40 percent of ordinary rates, this determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979.

Mr. Clark petitioned the Tax Court for review of the IRS determination. A trial was held in the Tax Court at which Mr. Clark, the NL official who represented NL in the acquisition, and Mr. Clark's attorney provided testimony on the negotiations between the parties. The Tax Court, in a reviewed decision with no dissents among the fifteen participating judges, held in favor of Mr. Clark. Pet. App. 15a-39a.

The Fourth Circuit affirmed, with no dissents. Pet. App. 1a-14a. It rejected petitioner's "hypothetical" view of the

---

[3] All statutory references are to the Internal Revenue Code of 1954, 26 U.S.C., as in effect for the year 1979, unless otherwise specified.

[4] Because of a computational error, the amount of gain actually reported on the return was $3,195,294. In the later computation for entry of decision by the Tax Court, Mr. Clark stipulated that the amount of gain recognized and reported should have been $3,250,000. J.A. 66.

[5] Pursuant to section 356(a)(2), the amount claimed to be taxable as a dividend is $2,319,611, the stipulated amount of the accumulated earnings and profits of Basin on the acquisition date. J.A. 29.

transaction (Pet. App. 8a), "characterizing [the boot] as a dividend paid by Mr. Clark's company immediately before the reorganization." Pet. App. 1a. That characterization, the court of appeals held, "fails to recognize that the cash was an integral part of a reorganization." *Id.* 1a-2a. Considering the receipt of cash as part of "the transaction in its entirety," the court held, it was properly regarded as "a cash payment by N.L. in return for Mr. Clark's relinquishment of a portion of his interest in the newly reorganized corporation." *Id.* 2a. Since the reduction exceeded the 20 percent threshold of section 302(b)(2), Mr. Clark was, the court found, entitled to capital gain treatment.

SUMMARY OF ARGUMENT

In 1979, Basin, the company then owned by respondent, Mr. Clark, was acquired by NL, a large publicly held company, in a transaction that qualified as a "reorganization" under section 368 of the Internal Revenue Code. NL offered Mr. Clark a choice between receiving, for his Basin stock, either 425,000 shares of NL stock or 300,000 shares and $3.25 million in cash. Mr. Clark chose the latter option. As a result of the exchange, therefore, Mr. Clark received cash plus an ownership interest in NL which was reduced by some 30 percent to reflect the cash payment.

The sole issue in this case is whether the court of appeals was correct in holding that the $3.25 million that Mr. Clark received was properly treated as all capital gain, because receiving the cash had the effect of substantially reducing his interest in the continuing enterprise that emerged from the reorganization. By contrast, petitioner contends that the distribution of the cash should be viewed in isolation, as if it had been paid by Basin as a dividend before, and independent of, the reorganization, and taxed as ordinary income, to the extent of the earnings and profits of Basin. That the court of appeals was correct follows from basic tax principles and from the reality of the situation.

When, in a transaction qualifying as a "reorganization", the shareholders of the acquired corporation receive cash (or other consideration besides stock of the acquiring corporation), the tax treatment of that "boot" is governed by section 356. Section 356(a)(1) makes the boot taxable up to the amount of gain on the transaction. Section 356(a)(2) governs the character of the income: the boot is taxable as capital gain, unless the exchange of the stock for cash and stock "has the effect of the distribution of a dividend."

The court of appeals, following the analysis previously adopted in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), held that whether the exchange had the "effect of a dividend" must be measured by reference to the effect of the exchange in which the cash was received on Mr. Clark's continuing interest in the reorganized NL-plus-Basin corporation. The integrated approach thus employed by the court below is supported by basic tax principles, while the artificially bifurcated approach of the petitioner violates them.

This Court has held that the hallmark of a non-dividend distribution is a "meaningful reduction of the shareholder's proportionate interest in the corporation." *United States v. Davis*, 397 U.S. 301, 313 (1970). It is a basic principle of tax law that in a reorganization there is both a continuation of the pre-transaction businesses and a continuity of ownership of those businesses. *Paulsen v. Commissioner*, 469 U.S. 131 (1985). Accordingly, the "effect" of the exchange here, and specifically whether it resulted in a "meaningful reduction" in Mr. Clark's shareholder interest, must be measured by the effect of his receipt of cash on his interest in the continuing enterprise. By that standard, there was no dividend, for the receipt of cash reduced his continuing ownership interest by some 30 percent, clearly enough to preclude dividend treatment.

The petitioner's view—that the cash should be treated as a separate pro rata distribution to Mr. Clark, independent of the overall reorganization of which it was a part—is not only inconsistent with the continuity principles of reorganizations. It also ignores the "step transaction" doctrine whereby, rather than giving separate consideration to each of the various steps which make up an integrated transaction, they are viewed together to determine their tax effect. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). The court below applied this basic principle of federal income taxation; the petitioner's approach exemplifies just the artificial fragmentation that the step transaction doctrine was created to prevent.

Further, in measuring the significance of the diminution of Mr. Clark's interest in NL, it was proper for the court of appeals to apply the principles of section 302, dealing with the treatment of corporate distributions as dividends or redemptions. Section 302 treats a distribution in redemption of stock as an exchange, with the gain eligible for capital gain treatment, unless the distribution is "essentially equivalent to a dividend," and it establishes detailed rules for determining that equivalence. Because of the similarities in the terms and objectives of section 302 and section 356, and because of the desirability of a common standard in the area, the reliance on section 302 standards here was reasonable and correct. The relevance of the section 302 standards to section 356(a)(2) has been acknowledged by other courts, the Internal Revenue Service, and, most importantly, by Congress.

Indeed, the approach of the courts below—both in taking an integrated approach and in looking to section 302 for guidance—has been broadly endorsed by commentators and recommended for statutory codification by the American Bar Association and the staff of the Senate Finance Committee. It has, in fact, been pronounced "acceptable" by the tax policy authorities at the Treasury Department, in

the context of the pending revision of the corporate reorganization provisions of the Internal Revenue Code.

By contrast, petitioner's insistence that the cash portion of the transaction be viewed only with reference to Mr. Clark's ownership of Basin (and, hence, be viewed as a "pro rata" distribution) ignores the facts, as well as these basic tax principles. Petitioner's view would resurrect an automatic dividend rule, and would be subject to manipulation and abuse. Moreover, the legislative history of section 356(a)(2), as well as this Court's decision in *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), which dealt only with a single corporation recapitalization, do not lend any support to petitioner's position. Nor does the claimed "long and consistent line of court of appeals cases" truly exist. Of the post *Bedford* cases, only *Wright*, supra—whose analysis was adopted by the court of appeals here—and *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978)—which follows the unrealistic bifurcation approach urged by petitioner—discuss the issues presented here in any systematic way. The integrated analysis of the court of appeals, which was also employed by *Wright* and has been broadly accepted by expert observers, offers the correct solution to measuring whether, in an acquisitive reorganization such as occurred here, an exchange involving boot had the effect of a dividend.

ARGUMENT

I. THE COURTS BELOW CORRECTLY DETERMINED THAT THE EXCHANGE IN WHICH MR. CLARK RECEIVED CASH FROM NL DID NOT HAVE THE EFFECT OF A DIVIDEND.

The question presented by this case involves fundamental principles underlying the reorganization provisions of the Internal Revenue Code. Under those provisions, an acquisition of one corporation by another in a transaction that qualifies as a reorganization is accorded non-recog-

nition treatment to the extent that the shareholders of the acquired corporation exchange their stock for stock in the acquiring corporation. If the shareholders also receive cash for their stock, the cash is taxable up to the amount of gain on the exchange. And, the taxable amount is treated as a capital gain, unless the "exchange" of stock for cash and stock "has the effect of the distribution of a dividend." Section 356(a)(2).

The issue raised here is whether Mr. Clark's exchange of Basin stock for NL stock plus cash should be taxed at capital gains rates or as a dividend. Both the Tax Court and the court of appeals were unanimously of the view that dividend effect should be measured by treating the reorganization—*i.e.*, the merger of Basin into NL and the exchange of Basin stock for NL stock and cash—as an integrated transaction. The focal point of the inquiry by the courts was therefore the effect of the entire *exchange* on Mr. Clark's *continuing interest* in the reorganized corporation—not, as petitioner maintains, the effect of the *cash* in isolation on Mr. Clark's *former* interest in the absorbed corporation. In measuring that effect, the courts below applied the principles of section 302, which contains standards for differentiating cash distributions treated as dividends from cash distributions treated as payments in exchange for stock.

The approach taken by the courts below is in accord with basic principles, expressed by this Court, underlying the reorganization and dividend provisions of the Internal Revenue Code. It is also supported by a substantial body of authority, including the decision of the Eighth Circuit in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), the opinions and analyses of leading scholars and commentators, the intent of Congress expressed in connection with a recent clarifying amendment to the statutory provision in issue, and the policy views of the Treasury Department.

A. The Test of a Dividend is Effect on Post-Payment Ownership.

The fundamental issue here is whether the realistic, integrated view of the transaction taken by the Fourth Circuit was correct. That it was correct follows from holdings of this Court and from basic tax principles.

1. There Is No Dividend When There Is a "Meaningful Reduction" in Ownership Interest.

Under section 356(a)(2), a transfer of stock and cash to shareholders participating in a reorganization must have the "effect of a distribution of a dividend" for ordinary income treatment to be required. This Court has, in *United States v. Davis*, 397 U.S. 301 (1970), defined a dividend as a distribution to a shareholder "without a change in the relative economic interests or rights of the shareholder." 379 U.S. at 313. In contrast, it has said that if receiving cash results in a "meaningful reduction of the shareholder's proportionate interest in the corporation," the transaction is not a dividend distribution. *Id.* In the latter situation the shareholder is considered to have sold a portion of his equity interest to the corporation for cash, resulting in exchange rather than dividend treatment.

In determining whether Mr. Clark's choice of the part-stock, part-cash offer "had the effect of a dividend" the determining factor is, therefore, whether it produced a "meaningful reduction" in his "relative economic interest" as a shareholder.

2. "Meaningful Reduction" Must Be Measured With Reference to Reorganized, Continuing Enterprise.

When, as here, cash is received as part of an exchange in a merger that simultaneously transforms the entity in which the ownership interest is held, the effect of the cash can be measured meaningfully only by considering the effect of the exchange in the

context of the transaction *as a whole*, as the courts below did, not as if the cash had been received in isolation, as the petitioner would have this Court do.

a. A Reorganization Results in a Continuing Enterprise With Continuing Ownership Interest.

The acquisition of Basin by NL constituted an "A reorganization" under section 368(a)(1)(A) and (c)(2)(D). The need to measure dividend effect in the context of the whole reorganization transaction follows from the nature of tax-free reorganizations.

It is a basic concept underlying the special treatment of "reorganizations" under the federal income tax law that the entity which emerges from the reorganization is a continuation, in modified corporate form, of the business enterprises that participated in the reorganization. Indeed, one of the fundamental requirements for reorganization treatment of an acquisition is that the shareholders of the acquired corporation receive in the transaction a sufficient ownership interest in the surviving entity to establish a "continuity of proprietary interest."[6] When that standard is met in an acquisitive reorganization, such as occurred here, the shareholders of the acquired corporation are considered to have continued their investments in the acquired corporation by virtue of the ownership interests which they receive and retain in the enlarged, surviving entity.

This concept of continuing ownership in a continuing entity applies equally where, as here, there is a great disparity in the size of the parties to the reorganization: When Basin was absorbed, the slightly enlarged NL that emerged from the reorganization was the continuation not only of NL's prior business, but also of Basin's. Indeed,

---

[6] *See, generally*, Treas. Reg. § 1.368-1(b); *Paulsen v. Commissioner*, 469 U.S. 131 (1985); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951).

NL's purpose in making the acquisition was to be able to continue Basin's business. J.A. 44. Similarly, the continuity of proprietary interest doctrine means that for tax purposes, Mr. Clark's ownership interest in Basin did not terminate. Rather it continued uninterrupted in his ownership interest in the new, enlarged NL, just as the NL stockholders' prior ownership in NL alone continued in the enlarged, new enterprise which absorbed Basin's business activities.

b. The Character of Taxable Boot Depends on the Effect of Its Distribution As Part of the Reorganization Exchange.

The tax-free treatment afforded reorganizations—and the special limitations on that treatment at issue here—follow from this basic proposition that a reorganization involves a continuing enterprise in which ownership continues as well. Specifically, in a qualifying reorganization, gain is—contrary to the general rule of section 1001(c)—not recognized by the shareholders of the corporations involved even though the business represented by their stock has, in a merger, been transformed and enlarged. This tax-free treatment is accorded because a reorganization transaction is "deemed insufficiently closed economically to justify a tax at the time, except insofar as the stockholder gets something in addition to stock or securities in the reorganized company." *Lewis v. Commissioner*, 176 F.2d 646, 648 (1st Cir. 1949). *See also Paulsen v. Commissioner*, 469 U.S. 131, 136 (adopting description of a reorganization as "recasting the same interests in a different form").

Consistent with these principles, no gain is recognized where only stock or securities are received in a reorganization. Section 354(a)(1). However, in reorganizations in which the shareholders of the acquired corporation also receive cash or other non-stock consideration—commonly called "boot"—in the reorganization, a special statutory

rule applies to govern the tax consequences of receiving the boot. This rule (section 356(a)(1)) provides that if the shareholders of the acquired corporation receive cash or other property in addition to stock or securities, they must recognize gain on the transaction up to the amount or fair market value of the boot.

Mr. Clark has, pursuant to this provision, paid tax on the full amount of the cash boot he received. The sole issue in this case is the *character* of the income—capital gain or ordinary income—that Mr. Clark recognized pursuant to section 356(a)(1).

Section 356(a)(2) governs the characterization of the amount of income required to be recognized by section 356(a)(1). That characterization rule provides for dividend treatment as a possible, not as a certain, result of receipt of boot. Of course, a straight sale of stock for cash generally results in capital gain treatment, and, consistent with that, section 356(a)(2) declares that only if the exchange involving the receipt of stock plus boot "has the effect of the distribution of a dividend" to the distributee shareholder must the boot be treated as a dividend, taxed at ordinary income rather than capital gain rates.[7]

c. The Effect of a Boot Distribution Must be Measured by the Effect of the Exchange on Continuing Ownership Interest.

In accordance with this Court's definition of a dividend and with the basic principles of the reorganization provisions, the question posed by section 356(a)(2) must be addressed, as the courts below did here, with reference to the shareholders' continuing interest in the surviving corporation.

---

[7] Under section 356(a)(2), the amount treated as a dividend is limited to the distributee shareholder's ratable share of accumulated earnings and profits of the corporation.

As noted above, the factor that distinguishes a dividend distribution from a distribution in exchange for stock is that in the latter case, as consideration for the distribution, there is a corresponding, "meaningful" reduction in the shareholder's equity interest—*i.e.*, in the shareholder's voting rights, right to participate in future earnings, and right to share in liquidation proceeds. *United States v. Davis*, *supra*; *see also Wright v. United States*, *supra*, at 607-08. Moreover, the basic assumption of a tax-free reorganization is that the shareholder's investment has not terminated, but rather continues in the reorganized, surviving entity. Both of these concepts dictate that the dividend effect of an exchange including boot be measured from the standpoint of the shareholder's equity interest in the entity that survives the reorganization and continues to be engaged in business, not with reference to his former, now vanished, ownership in the acquired corporation, which ceases to exist as a separate entity with the reorganization.

Moreover, the language of section 356(a)(2) suggests this result. It speaks in terms of the possible dividend effect of the *exchange*, not simply the dividend effect, in isolation, of the cash. To measure the effect of the *exchange*, it is necessary to consider the overall transaction and determine whether the shareholders experienced a meaningful reduction in their interest in the reorganized entity that emerges from the exchange.

So determined, there was clearly no dividend here. The undisputed consequence of the exchange by Mr. Clark of Basin stock for NL stock plus cash was that Mr. Clark had a significantly smaller ownership interest in the continuing enterprise—by some 30 percent—than he would otherwise have had if the exchange had involved entirely NL stock.[8] In the court of appeals' words, the effect of

---

[8] As discussed in more detail below, pp. 18-22, in determining whether the reduction in Mr. Clark's interest was sufficiently substantial to be

the distribution was Mr. Clark's "relinquishment of a portion of his interest in the newly reorganized corporation." Pet. App. 2a. Such an effect is inconsistent with that of a dividend.[9] On the record in this case, there is, therefore, not the slightest doubt that receipt of the cash produced just that practical effect of reducing Mr. Clark's continuing ownership interest that under *Davis* unequivocally distinguishes it from a dividend.

3. The Step Transaction Doctrine Requires Applying the Dividend Equivalency Test at the Surviving Corporation Level.

Equally important, the approach of the courts below reflects a correct application of the step-transaction doctrine, while the petitioner's approach here would simply

---

inconsistent with dividend treatment, the courts below properly looked to the detailed standards of section 302. On any reasonable basis, however, a 30 percent reduction in the interest of a minority stockholder is economically significant and inconsistent with dividend status. See *e.g.*, Rev. Rul. 76-364, 1976-2 C.B. 91 (17.5% reduction is meaningful); Rev. Rul. 76-385, 1976-2 C.B. 92 (3.3% reduction in interest of small minority shareholder is meaningful). Evidently, the petitioner does not dispute that if the transaction is to be analyzed by comparing Mr. Clark's actual ownership in the continuing NL-plus-Basin enterprise with what he would have had absent the boot, the reduction is sufficient to make capital gain treatment appropriate. *Cf.* Pet. App. 35a.

[9] Petitioner suggests (Br. 37) that even if the exchange had the effect of a nondividend transaction (*i.e.*, a disproportionate redemption) it could still also have the "effect of a dividend" within the meaning of section 356(a)(2). The fatal difficulty with this is that a dividend and the redemption transaction to which the court of appeals properly analogized the exchange are mutually inconsistent in their effects. The courts below found that in economic effect, the boot meaningfully reduced Mr. Clark's continuing relative interest in the continuing enterprise. Since this Court has held that it is the absence of such an effect on relative interests that is the distinguishing feature of a dividend, that conclusion logically excludes the transaction having the effect of a dividend.

ignore this basic principle of tax analysis.[10] The step-transaction doctrine is a well established principle of tax law, used (indeed, embraced) more often as a sword by the petitioner than as a shield by taxpayers. Under this doctrine, rather than giving separate consideration to each of the various steps which comprise an integrated transaction, the steps are viewed together in light of the overall transaction to determine their tax effect. *See, e.g., Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954).[11] Indeed, the IRS routinely uses the step transaction doctrine to analyze the tax effects of transactions similar to the NL-Basin merger. *See* Rev. Rul. 75-447, 1975-2 C.B. 113; Rev. Rul. 75-360, 1975-2 C.B. 110.[12]

---

[10] Nowhere in the petitioner's brief is this basic doctrine even mentioned.

[11] The situation in *Zenz v. Quinlivan* is particularly instructive here. In *Zenz*, the taxpayer wished to sell all of her stock in a corporation in which she was the sole shareholder. To satisfy the objective of the purchaser (who did not want to buy all the stock) the parties agreed upon a plan under which the purchaser bought part of the stock and the corporation redeemed the remaining shares. The court viewed the steps in the transaction as part of an integrated plan intended to terminate the taxpayer's holdings in the corporation. As a result, the redemption was held not essentially equivalent to a dividend because, *taken together with the sale*, the redemption completely terminated the shareholder's interest in the corporation.

[12] In Rev. Rul. 75-447, the IRS approved the *Zenz* result and extended it to situations where, as part of a plan, a corporation redeems some stock of existing shareholders and issues stock to a new shareholder. According to the ruling, "in situations where the redemption is accompanied by an issuance of new stock . . . or a sale of stock . . . *and both steps (the sale, or issuance, of stock, as the case may be, and the redemption) are clearly part of an integrated plan to reduce a shareholder's interest*, effect will be given only to the overall result for purposes of section 302(b)(2) and the sequence in which the events occur will be disregarded." (emphasis added)

The approach taken by the Tax Court and the court of appeals is fully consistent with the step transaction doctrine. Pet. App. 13-14a. It focuses on the overall transaction and treats the boot, taken together with the transfer of NL stock to Mr. Clark, as what it in fact was—a payment in consideration for Mr. Clark's acceptance of a lesser interest in the continuing NL enterprise which emerged from the reorganization. Petitioner, on the other hand, attempts to bifurcate the transaction and treat the boot as if it were distributed by Basin prior to the merger, followed by an entirely unrelated transfer of NL stock to Mr. Clark in connection with the merger of Basin into NL. It is just such artificial fragmentation of integrated transactions that the step transaction doctrine was created to prevent.

4. The Economic Substance and Factual Record of the Present Transaction Strongly Support Measuring Dividend Equivalency By the Exchange's Effect on Ownership in the Surviving Corporation.

In the present case, the facts strongly support the approach taken by the courts below. Mr. Clark's acceptance of less NL stock as the consequence of taking the cash was far from notional; it was a real and conscious choice. At trial, the participants testified in detail to the events leading up to this choice. The Tax Court found the facts as follows: At the culmination of negotiations for the acquisition of taxpayer's corporation, NL's representatives offered Mr. Clark a choice: In exchange for Mr. Clark's stock in Basin, NL was willing to give him either (1) 425,000 shares of NL common stock and no cash, or (2) a combination of 300,000 shares of common stock and $3,250,000 cash. Pet. App. 16a. The initiative for the cash offer came from NL, not Mr. Clark, and it was based on NL's desire to minimize the number of shares outstanding. Pet. App. 37a. The net effect of Mr. Clark's accepting the combined stock and cash offer was therefore that his per-

centage ownership in the surviving, continuing entity after the reorganization was reduced to barely 70 percent of what it would have been had he received all-stock.[13]

The Tax Court also noted additional economic circumstances of the transaction that confirm the correctness of its conclusion that the transaction did not have the effect of a dividend under section 356(a)(2). These included the lack of "the slightest evidence of a concealed distribution" from Basin, and Basin's lack of practical ability to make such a payment, since it exceeded not only its cash and accumulated earnings, but its total assets. Pet. App. 37a.

These facts highlight the realism of the approach used by the courts below and the artificiality of the petitioner's approach in viewing the transaction as an independent distribution by Basin.[14]

---

[13] Mr Clark took the cash because he saw the offer as an opportunity to liquidate part of his stock interests, for which he would otherwise have had to wait until restrictions on transfer of the NL stock expired. J.A. 58. Contrary to petitioner's implications (Br. 33-34) these motives are the concerns of a person focusing on the wisdom of committing so much of his capital to NL stock as the all-stock offer entailed, not of a person seeking to bail out earnings of Basin.

[14] Petitioner's contention (Br. 33, citing *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974)) that the integrated approach effectively repudiates the form chosen for the transaction is misdirected. In form, as well as in substance, the effect of the exchange was that Mr. Clark received cash plus a smaller interest in NL. The cash came from NL not Basin; the initiative for offering the cash came from NL's acquisition negotiator, not from Mr. Clark as a final act as controlling shareholder of Basin; and the cash reduced Mr. Clark's continuing ownership by a precisely measurable and meaningful amount. The all-stock alternative is relevant precisely because it did *not* happen and because the effect of taking the stock-plus-cash option and not following that other course was to change Mr. Clark's relative economic interest.

B. The Courts Below Properly Looked to Section 302 in Applying the Dividend Equivalency Test at the Surviving Corporation Level.

The courts below held that the effect of the cash on Mr. Clark's relative ownership interest should be tested under the principles of section 302, which governs redemptions, to determine whether in receiving the cash "Clark yielded a sufficient portion of his corporate control" to be entitled to capital gain treatment.[15] Pet. App. 5a. Therefore, they compared, using the standards of section 302(b)(2), Mr. Clark's percentage interest in the surviving, enlarged NL-plus-Basin business with the percentage interest in that business that Mr. Clark would have obtained without the cash distribution, under the all-stock alternative.

1. Section 302(b) Is an Appropriate Guide Because It Is Concerned With the Same Issues as Section 356(a)(2).

Section 302, dealing with the tax effects of redemptions of stock, is relevant to section 356(a)(2) because it contains similar language and addresses a similar issue. Section 302 treats cash received in a redemption as a dividend if the distribution is "essentially equivalent to a dividend." Section 302(b)(1). This language is very close in phrasing, and identical in substance, to section 356(a)(2)'s standard of whether a boot distribution has "the effect of a dividend." In addition, the purposes of the two sections are con-

[15] Contrary to the petitioner's claim (Br. 28) what he characterizes as the court of appeals' "abstract" discussion of the applicability of section 302 was not the foundation of its analysis; nor did it fail to "directly examine the merger transaction." Br. 27. Rather, the court of appeals recognized (Pet. App. 7a) that the critical question was not whether section 302 applied, but whether to take an integrated view of the transaction under section 356(a)(2), and it proceeded to analyze that issue in detail. Thus, application of section 302, although it is entirely appropriate, is not essential to the logic or correctness of the holding below.

gruent—both serve to differentiate between distributions which should be viewed as payments in exchange for stock and distributions which should be treated as dividends. Finally, section 302, in contrast to the spareness of section 356(a)(2), provides elaborate definitions of when the dividend equivalence test is met. Separate definitions for the functionally similar cases of section 302 (redemptions) and section 356 (reorganizations) would not only be confusing; they would create unnecessary and dysfunctional distortions in tax treatment depending upon the form of the transaction.

2. The Section 302 Analysis Employed By the Court of Appeals Has Been Widely Accepted.

In applying both the redemption analogy and the dividend effect standards of section 302 to this section 356(a)(2) problem, the courts below were not only following the logic of the statute, but the weight of authority. That approach has been approved also by other courts, by the Internal Revenue Service, by the Tax Division of the Justice Department, and by Congress.

The courts have stated that the two sections are to be read *in pari materia*. *See Wright v. United States*, *supra*, at 605; *King Enterprises, Inc. v. United States*, 418 F.2d 511, 520-21 (Ct. Cl. 1969); *Ross v. United States*, 173 F. Supp. 793, 797, (Ct. Cl. 1959), *cert. denied*, 361 U.S. 875 (1959); *Hawkinson v. Commissioner*, 235 F.2d 747, 751 (2d

Cir. 1956). The Internal Revenue Service has also adopted this position in published rulings[16] and in its litigating position.[17]

More importantly, Congress, as well, has affirmed the correctness of this position in connection with a recent amendment to section 356(a)(2). The Conference Committee Report for the Deficit Reduction Act of 1984, which made changes in the reorganization provisions, unequivocally stated that "[t]he principles of section 302 are applicable in testing for dividend equivalency under section 356." H.R. Rep. No. 861, 98th Cong. 2d Sess. 1, 845.[18]

---

[16] *See* Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 75-83, 1975-1 C.B. 112 ("In making this determination [under section 356(a)(2)] it is appropriate to look to principles developed under section 302 for determining dividend equivalency."); Rev. Rul. 84-114, 1984-2 C.B. 90. Indeed, petitioner himself cautions that his present attack on the court of appeals' reference to section 302 "is not to say that section 302 principles can never have any relevance to the section 356(a)(2) analysis." Br. 30 n.15. Moreover, although petitioner now claims that in the so-called pro-rata situation, there is no need to refer to section 302 principles, the IRS has, indeed, referred to section 302 to measure the dividend effect of boot in those situations, as well. *See* Rev. Rul. 75-83, 1975-1 C.B. 112.

[17] *See Wright v. United States, supra*, 482 F.2d at 605, where the Court noted: "The Commissioner argues that in defining the 'effect of the distribution of a dividend' under § 356(a)(2), the redemption provisions of § 302 should be applied." Petitioner's contention here (Br. 32) that this principle that the two sections should be read in *pari materia* means only that "in both situations it is necessary to look at 'all the facts and circumstances surrounding the distribution' " is nonsensical and is belied by the very cases that have adopted this principle. In any event, petitioner's position requires ignoring the most important of the "facts and circumstances," here, namely, the reorganization context of the exchange.

[18] The amendment made to section 356(a)(2) in 1984 was to state explicitly that the determination of whether a distribution has the effect of a dividend is to be "determined with the application of [the attribution rules of] section 318(a)." This amendment would have little, if any, meaning unless it were assumed that the tests for determining

Such express Congressional recognition of the judicial and administrative interpretation of a statute should be given great weight by the court in determining the meaning of the relevant provisions. *Cf. Lorillard v. Pons*, 434 U.S. 575, 580 (1978); *Slatin v. Stanford Res. Inst.*, 590 F.2d 1292, 1293 (4th Cir. 1979); *Stout v. Hancock*, 146 F.2d 741, 744 (4th Cir. 1944), *cert. denied*, 325 U.S. 850 (1945).

3. The Technical Objections Petitioner Advances For Rejecting Section 302 Are Unsound.

The "major differences" advanced by the petitioner (Br. 34-35, 37-39) for distinguishing the effects of a receipt of cash in a reorganization under section 356(a)(2) from the receipt of cash in a redemption under section 302 are truly distinctions without differences insofar as the issue presented here is concerned.

Petitioner (Br. 34) argues that the approach of the courts below is contrary to the several cases which hold that section 356(a)(2) requires the amount treated as a dividend to be limited to the taxpayer's ratable share of the earnings and profits of the *acquired* corporation. Petitioner (Br. 38) points out that in a redemption exchange under section 302, the gain reduced by the basis of the redeemed shares is subject to tax as a capital gain, while in a reorganization exchange under section 356(a)(2) the entire amount of gain is subject to tax as capital gain. Petitioner also argues (Br. 38) that Mr. Clark's basis in the NL shares he did receive would have been differently calculated had he re-

---

dividend equivalency contained in section 302 are applicable. Thus, the tests contained in section 302 require a determination of the shareholder's percentage interest in the corporation before and after the distribution. For purposes of this determination, stock owned by individuals and entities which are related to the shareholder, within the meaning of section 318, are deemed to be owned directly by the shareholder. Unless the section 302 test of a change in ownership interest were to be applied for section 356(a)(2) purposes, there would be no need for an attribution rule to compute such ownership interests.

ceived the quantity of stock contemplated by the one-stock offer. Similarly, petitioner (Br. 39) points out that, if a payment of boot is subject to dividend treatment, the distributee shareholder's "ratable share of earnings and profits" is determined differently under section 356(a)(2) than would be the case under section 302.

However petitioner does not explain why (nor is there any reason why) these distinctions should stand in the way of applying section 302 principles to test for dividend equivalence in a reorganization exchange. Contrary to the petitioner's assertion (Br. 34-35) the court of appeals' holding does not require that the rules of section 302 be used to measure the *amount* of the dividend to the taxpayer. As prior cases have recognized, it is section 356(a)(1) that provides for recognition of gain on what would otherwise be a tax-free transaction and sets the basic rule for determining the *amount* of the gain. Section 356(a)(2) comes into play only to determine the *character* of the income recognized (subject to the gain limitation) by section 356(a)(1). *King Enterprises v. United States*, 418 F.2d 511, 520 (Ct. Cl. 1969). *See* B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 14.34, at 14-156 (5th ed. 1987). Thus, the special section 356 rules for measuring the amount of a dividend are no reason for ignoring economic reality or the principles of section 302 in determining whether there is a dividend at all.[19]

---

[19] Compare section 304(b)(1) with section 304(b)(2)(A). These sections address the treatment of a transaction in which one corporation distributes cash or property to a controlling shareholder in exchange for stock in a second corporation controlled by the same shareholder. Under section 304(b)(1), the determination of whether the distribution is to be treated as a dividend is made with reference to its effect on the shareholder's percentage interest in the second corporation. However, under section 304(b)(2)(A), the amount and source of the dividend is determined with reference to the earnings and profits of the first corporation (and as a result of a 1984 amendment, thereafter with reference to the earnings and profits of the second corporation).

In sum, the rationale for applying the section 302 dividend/exchange standards is sound, and the petitioner's arguments to the contrary do not detract from this conclusion.

C. The Approach of the Courts Below Has Received Widespread Approval.

The approach used by the courts below—both in taking an integrated view of the transaction and in applying the principles of section 302—has been endorsed by the American Bar Association,[20] and recommended for statutory codification by the Staff and the Chairman of the Senate Finance Committee.[21] It is supported by leading scholars and commentators.[22]

In fact, the executive branch has already decided that the approach taken by the courts below and in *Wright* and challenged by petitioner here is acceptable as a matter of tax policy. In 1983, the Treasury Department, through the Office of the Assistant Secretary for Tax Policy, stated that, in the context of the proposed revision of the re-

---

[20] *See* ABA Legislative Recommendation 1983-8 (approved by ABA House of Delegates at 1984 Midyear Meeting).

[21] *See* Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations*, 63 (S. Prt. 98-95, 1983); Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 217-18 (S. Prt. 99-47, 1985); Joint Comm. on Taxation, 99th Cong. 2d Sess., *Tax Reform Proposals in Connection with Committee on Finance Markup*, (JCS 8-86), (1986).

[22] *E.g.*, Levin, Adess, *et al.*, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 Tax Lawyer 287, 288 (1976); Golub, " 'Boot' in Reorganizations—The Dividend Equivalency Test of section 356(a)(2)," 58 Taxes 904, 911-13 (1980); Fleming, "Reforming the Tax Treatment of Reorganization Boot," 10 J. Corp. Tax'n 99, 107-110 (1983); Hurley, "Capital Gain Possibilities for Boot in Acquisitive Reorgs Lessened by Shimberg Case," 50 J. of Tax'n. 334, 338 (1979).

organization provisions, "on balance, we do not object to the Staff's recommended approach," which it described as measuring whether boot has the "effect of a dividend" by "look[ing] to the shareholders' reduction in interest as measured *after* the acquisition."[23]

This does not mean, of course, that adoption of this approach must await legislative action. As the discussion above indicates, the approach taken by the courts below and by the Eighth Circuit in *Wright* is the more reasonable, indeed compelling, result under the present statutory framework. It is only because of the IRS's unyielding position that legislative correction, as part of a total revamping of the corporate reorganization area, has recently come under consideration.

II. THE PETITIONER'S HYPOTHESIS OF A PRE-REORGANIZATION DIVIDEND WAS PROPERLY REJECTED.

A. Petitioner's Isolated View is Unrealistic.

Petitioner apparently does not dispute the principle that in testing dividend "effect" under section 356(a)(2), it is necessary to look to the relationships of the distributee shareholders before and after the distribution. *See* Br. 30. But the petitioner would have this Court adopt a wholly artificial view of what relationship existed after the distribution.

Petitioner maintains that the focal point should be the purely notional post-distribution holdings in the *acquired*

---

[23] *Reform of Corporate Taxation: Hearing Before the Committee On Finance United States Senate*, 98th Cong. 1st Sess., 24-25 (S. Hrg. 98-556, 1983) (statement of Ronald A. Pearlman) (emphasis in original); *see also* Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 3 (S. Prt. 99-47, 1985).

corporation, Basin.[24] Specifically, petitioner's view of the transaction is that, as an unrelated event, before the NL acquisition, Mr. Clark used his control of Basin to require a massive cash distribution by it. Br. 20. Taking such a view requires blindly ignoring practically every relevant fact about the transaction:

First, the cash was not paid in an isolated transaction, leaving Mr. Clark still the sole shareholder of Basin. Rather, it was paid as an integral part of the reorganization in which Basin's identity—and Mr. Clark's position as a sole shareholder—was submerged in the enlarged NL-plus-Basin entity, and in which Mr. Clark's minority shareholder interest in that entity was diminished by reason of having received the cash.[25] Indeed, petitioner's view entails the absurdity of applying section 356(a)(2)—a rule for reorganizations—by steadfastly ignoring the very reorganization transaction that makes the provision applicable.

Second, the initiative for the cash element in the transaction came from NL, not from Mr. Clark, who had previously sought an all-stock deal. The only control Mr. Clark exerted in this regard was his choice of a reduced continuing ownership in the enlarged corporation in exchange for cash. NL made the offer because it wanted to reduce the amount of new stock it issued in the acquisition. These facts show the utter artificiality of the petitioner's reliance on a commentator's "intuition"—his term, adopted by

---

[24] The petitioner ridicules the court of appeals for resorting to a "hypothetical scenario" of a redemption. Br. 27 *et seq.* But the petitioner's own analysis resorts to an equally hypothetical, and far less realistic, scenario—the premerger declaration of a dividend by a controlling shareholder as an independent and separable step in the reorganization. Br. 20.

[25] Respondent does not argue, and the courts below did not hold, that dividend treatment is excluded merely by Mr. Clark's transition from being sole shareholder of the acquired company to being a minority shareholder of the enlarged NL entity.

petitioner's brief (Br. 20)—that "what is really going on" when NL offered Mr. Clark the part-cash option was Mr. Clark "making use of [his] last opportunity to withdraw profits from [his] corporation before [he] lose[s] control as a result of dilution by the reorganization." This characterization was expressly rejected by the court of appeals, which concluded that "there is no evidence of . . . a bailout in this case." Pet. App. 10a.[26] The Tax Court reached a similar conclusion that there was "not the slightest evidence that the cash payment was a concealed distribution from Basin." Pet. App. 37a.

Third, the cash was not paid by Basin but by NL. Indeed, Basin had neither cash on hand nor net assets sufficient to pay the cash. The Tax Court found that the amount of cash received by Mr. Clark "was not only far in excess of the accumulated earnings and profits ($2,319,611), but also of the total assets of Basin ($2,758,069)."[27]

Fourth, the extent to which receiving the cash resulted in changing Mr. Clark's relative continuing ownership interest is absolutely clear here: The undisputed testimony supports the trial court's finding that by taking the cash, Mr. Clark reduced his ownership in the continuing enterprise to about 70 percent of what it would otherwise have been.[28] This major change in Mr. Clark's ownership inter-

[26] The Tax Court described petitioner's hypothesis as a "twisted course" that requires "fantasizing" away the reorganization that invokes section 356. Pet. App. 30a.

[27] The Tax Court, accordingly, reached the following illuminating conclusion:

> In fact, only if one takes into account unrealized appreciation in the value of BASIN's assets, including goodwill and/or going concern value, can one possibly arrive at $3,250,000. Such a distribution could only be considered as the equivalent of a complete liquidation of BASIN, which would call for capital gain treatment under *Zenz v. Quinlivan, supra*. Pet. App. 37a.

[28] Petitioners suggest (Br. 34 n.18, 36) that the approach of the courts below creates valuation problems because there may be other cases in which it would be hard to measure the amount by which receipt of boot in such a transaction reduced the stock interest the stockholders of the acquired corporation would otherwise have had. The need to value assets or stock in a reorganization arises frequently in connection with other statutory and judicially engrafted requirements (*e.g.*, requirement that there be continuity of proprietary interest, and, in certain reorganizations, a transfer of substantially all of the properties). *See* Rev. Proc. 77-37, 1977-2 C.B. 568. Moreover, normally, the owners of an acquired corporation will be able to show that they could have received more stock if they had foregone cash. In any case, speculation about the difficulties of proof that might face other taxpayers is no reason to apply an unreasonable and unrealistic analysis in a case where there is no dispute about how much taking the cash diminished the taxpayer's continuing interest.

est, which was produced by his receiving the cash, is the antithesis of the lack of "change in the relative economic interest or right of the shareholder" that this Court has said is the distinctive feature of a dividend.

B. Petitioner Improperly Equates Mr. Clark's Receipt of Cash With a Dividend Effect.

Petitioner leaps from the fact that a pro rata distribution of cash to all shareholders of an ongoing corporation which has earnings and profits would be treated as a dividend to the conclusion that cash boot, at least if distributed to all of an acquired corporation's shareholders, has the "effect" of a dividend. Specifically, petitioner argues (Br. 11) that Mr. Clark "was in precisely the same position after the merger that he would have been in had the amount of Basin's accumulated earnings and profits been distributed to him as a formal dividend [before the merger], rather than as part of the boot received in the reorganization." The Court is told (Br. 19-20) without citation to the record, that "the distribution of such a dividend would have reduced the value of Basin by the amount of the dividend and accordingly reduced the amount of the boot that NL would have given in exchange for Mr. Clark's stock."

This speculation is entirely unsupported by the record, and is, indeed inconsistent with it. Basin did not have the cash—or even the net worth—to pay any such dividend. Basin's value to NL presumably lay, not in its nonexistent accumulation of liquid assets, but in its continuing potential to provide expert, specialized technical services to NL's downhole mining operations; at any rate, that is why NL proposed the acquisition of Basin. J.A. 44.

Petitioner goes further, to observe (Br. 20) that the shareholders of an acquired company "are the ones who earned the profits and allowed them to accumulate . . . rather than distributing them as dividends" and "are also the persons who negotiate the terms of the acquisition . . . including the extent to which there will be payment of boot." On this basis, petitioner argues that "the boot, then, appears to be simply a substitute for the undeclared dividend."

Insofar as it is not dependent on ascribing to the transaction elements of manipulation of which the trial court expressly found "not the slightest evidence," this view would logically require that the cash element in a sale of stock always be treated as a dividend to the extent of accumulated profits.[29] This whole body of theorizing is simply inconsistent with the basic policy of the tax law applicable in 1979, which was to tax liquidation of all or part of a shareholder's interest at lower rates, even though, as a matter of economic theory, the value of what was sold

[29] Of course, petitioner here limits his argument to cases where all shareholders receive proportionate cash boot. However, disproportionate distributions may still be dividends (*see, e.g.*, Rev. Rul. 85-106, 1985-2 C.B. 116), and in a disproportionate distribution to some shareholders of an acquired corporation, those shareholders would have cash which they could have received if disproportionate dividends had been paid earlier. Only by reference to the effect of receiving the cash on their interests in the surviving corporation can the situation be distinguished. Yet that effect, petitioner maintains, must be ignored.

may reflect accumulated profits—and always reflects expected profits.

C. The Distribution Was Not Pro Rata On a Realistic View.

Petitioner endlessly repeats that a pro rata cash distribution to stockholders of a corporation is a dividend, and that is certainly true because a truly pro rata distribution does not affect relative economic interests. The term "pro rata," however, is applicable here only if the distribution in issue is viewed as having been made to Mr. Clark in exchange for, or in respect of, shares in Basin with Basin remaining in existence and Mr. Clark still continuing as its sole shareholder.

The fatal difficulty with describing this distribution as pro rata is that, simultaneously with the distribution, Mr. Clark ceased to be the sole shareholder of Basin and became instead one of many shareholders in NL. The NL shareholders were at the same time also making a transformation from being shareholders only in NL's business to being shareholders in the enlarged NL-Basin combination being created. Viewed in relation to this larger class, which both sets of shareholders were joining as a result of the transaction of which the boot payment was a part, the distribution to Mr. Clark was not pro rata, but disproportionate. Mr. Clark was the only shareholder in this larger class to receive cash, and the cash did not leave untouched his relative economic interest in the larger, newly created corporation; rather it produced a substantial shrinkage in his interest.

D. Petitioner's Approach Is Subject to Manipulation and Abuse.

The rule advanced by petitioner would offer substantial opportunities for manipulation, especially where there was some overlap of ownership between the acquired and acquiring companies.

One example of the potential for such abuse is set out in the Tax Court's opinion. Pet. App. 12a. The example involves a situation where a single shareholder, A, owns 30 of 100 shares of Corporation X, which is worth $100, and holds all 100 shares of Corporation Y, which is also worth $100. Corporation X merges with Corporation Y creating XY corporation, a new company worth $200. As consideration for the merger, Shareholder A receives 110 shares of XY stock plus $20, instead of the 130 shares of XY stock he would have received in an all-stock transaction. The remaining shareholders of Corporation X receive only XY stock. After the reorganization is completed, therefore, A owns 110 of the 180 shares (61 percent) of XY and has $20.

Under petitioner's premerger distribution approach, A would be accorded capital gain treatment for the cash, since the cash would be viewed as having been paid by Corporation X in a non-pro rata redemption of 20 shares of A's Corporation X stock. The effect of the redemption, tested *solely from the standpoint of the shareholdings in Corporation X*, is a reduction of A's percentage interest from 30 percent (30 out of 100) to 13 percent (10 out of 80).[30] Under this Court's decision in *Davis*, as well as under section 302(b)(2), this would be a sufficiently large reduction in A's percentage interest in Corporation X to qualify for exchange treatment.

In contrast, under the integrated approach adopted by the courts below, the effect of the boot distribution would be considered from the standpoint of the overall merger transaction. In point of fact, A gave up a larger interest in the combined corporation (as Mr. Clark did here) in

[30] Even if part of the cash were deemed to come from Corporation Y, A would, on the petitioner's view, remain the only shareholder in X to receive cash, and hence at least part of the distribution would be non-pro rata, unless, of course, petitioner really maintains that any receipt of cash is a dividend.

return for the cash. In an all-stock transaction, A's interest would have been 130 shares or 65 percent of the 200 shares outstanding. Instead, A received $20 and 110, or 61 percent, of the 180 shares outstanding. Under this integrated analysis, since A remains a majority stockholder, the percentage reduction in A's interest would presumably not be substantial or "meaningful" under section 302, and dividend treatment would result.[31] *See, e.g.*, Note, *Boot Distributions in Acquisitive Reorganizations: The Wright-Shimberg Controversy*, 59 S. Cal. L. Rev. 1295 (1980); Levin, Adess, *et al.*, "Boot Distributions in Corporate Reorganizations--Determination of Dividend Equivalency," 30 Tax Lawyer 287, 296-98 (1976).[32]

[31] Moreover, under the integrated analysis, characterization is unaffected by which company is treated (either by the people who arrange the transaction or by the IRS) as paying the cash.

[32] Another possibility for abuse, involving Wall Street arbitragers, has come to light recently, as a result of publicity given to the Tax Court's opinion in this case. Because of the dividends received deduction for corporations (which was 85% through 1986 and is currently 80%, *see* section 243), it is more advantageous for a corporate shareholder to treat a payment from a corporation in which it owns stock as a dividend rather than a payment in exchange for the stock, which is not eligible for the deduction. Wall Street arbitragers purchase stock in a corporation before an acquisition transaction is closed and realize profits on the spread between the market price and the takeover price. If the acquisition is structured as a tax-free reorganization including some cash distribution pro rata to shareholders of the acquired corporation, corporate arbitragers could, under the approach favored by the petitioner, buy stock in the target and treat the boot (up to the amount of their gain on the arbitraging transaction) as a dividend, taxed at a much lower effective rate (after giving effect to the dividends received deduction) than if the boot were treated as capital gain on the transaction. According to a tax partner at one of the national accounting firms, "This [Clark] decision could eliminate many arbs from the takeover game." *See* "Tax Court Decision Could Ruin Risk Arb Biz," Investment Dealers' Dig. (February 17, 1986), 2.

It is worthy of note that although petitioner rejects an integrated analysis on the facts of Mr. Clark's case, he has applied such an analysis

No doubt because of these difficulties in applying petitioner's premerger dividend approach to reorganizations generally, petitioner avoids embracing it in situations involving corporations with common ownership.[33] Br. 31 n.16. It works equally badly in other types of reorganizations (e.g., a merger in which a very large corporation merges into a very small corporation).[34] In the Tax Court, petitioner proposed a five-part threshold test which would have to be satisfied before applying its approach. *See* petitioner's Opening Brief in the Tax Court, p. 27.[35] Far from bolstering petitioner's position, the need (if abuse potentials are to be avoided) to draw complex and uncer-

(relying on *Zenz v. Quinlivan, supra*) to these very similar arbitrage situations in order to deny dividend treatment for the boot. *See* Priv. Ltr. Rul. 8431003 (April 19, 1984); Gen. Couns. Mem. 39290 (Sept. 27, 1984).

[33] In Rev. Rul. 84-114, 1984-2 C.B. 90, the IRS applied the integrated approach (and section 302) to a recapitalization. The ruling was limited to a "situation involving a single corporation," but no rationale is given for the limitation.

[34] Under petitioner's approach, the effect of a boot distribution to a shareholder of one of the parties to an acquisitive reorganization will have drastically different results depending upon which corporation survives the merger. *See*, Levin, Adess, *et al.*, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 Tax Lawyer 287, 298 (1976).

Prof. Kyser, on whom petitioner relies heavily, rejects petitioner's approach in common control cases. Kyser, "The Long and Winding Road: Characterization of Boot under Section 356(a)(2)", 39 Tax. L. Rev. 297, 300 (1984).

[35] The five conditions were:

> [1] a small corporation (the "minnow") [is] merged into a large corporation (the "whale"), [2] there [has] been no previous commonality of ownership between the two corporations, [3] the "minnow's" shareholders [receive] cash and stock on a pro rata basis, [4] the "minnow's" shareholders' stock ownership in the "whale" [is] very small vis-a-vis the number of shares outstanding, and [5] the acquired corporation [has] a significant amount of accumulated undistributed earnings and profits.

tain distinctions that are nowhere reflected in the statute adds further support to the conclusion that the only approach that makes sense from a practical and realistic standpoint is the integrated approach adopted by the courts below. When the effect of the boot distribution is considered in the context of the overall transaction, there is no need for such complicated and contortive rules.[36]

E. The Legislative History of Section 356(a)(2) Does Not Support the Petitioner's Position.

Nothing in section 356 itself, nor in its legislative history, suggests a need or intent to adopt the unrealistic definition of "dividend effect" petitioner advocates. The "boot-dividend" rule entered the tax law in 1924, when the predecessor to section 356(a)(2) was enacted. The tax writing committees were apparently concerned about an abuse situation where, to effect a distribution to its shareholders of cash taxed at capital gain rates, a *single* corporation reincorporated in a transaction which qualified as a reorganization.

The only example contained in the 1924 Committee Reports to show "the necessity for this provision" follows that pattern. In the example, the corporation in question

[36] It is true that in virtually all cases where a shareholder of a "minnow," or small, closely held corporation, receives a combination of cash and stock in a "whale," or publicly held corporation, the reduction in ownership interest in the surviving, publicly held corporation attributable to the cash distribution will be "meaningful" and, therefore, will qualify for capital gain treatment. This does not, however, mean that the lower courts' approach here establishes an automatic capital gain rule. Rather capital gain treatment results because, as has been repeatedly recognized by the IRS, even a quite small reduction in the interest of a minority shareholder will generally be a "meaningful reduction" under section 302(b)(1). *See, e.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92. However, as shown in the example discussed above, pp. 29-31, in other situations, the integrated approach will properly yield dividend treatment.

had $50,000 of accumulated earnings and profits which, if distributed "as a dividend to its shareholders" would have been taxed at the full surtax rates. Instead, the corporation formed a subsidiary and transferred its assets and liabilities to the subsidiary (in a transaction which qualified as a reorganization) in return for stock and $50,000, which was then distributed to the corporation's shareholders. After the smoke had cleared, the owners of the corporation still had a continuing 100 percent equity interest in the corporation, but they also now had $50,000 of its accumulated earnings. The Committee Reports analyze the transaction as follows:

> Under the existing law, the $50,000 distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12 1/2 percent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. [H.R. Rep. No. 179, 68th Cong. 1st Sess., 14-15; *see also*, S. Rep. No. 398, 68th Cong., 1st Sess., 15-16].

The single corporation transaction described in the legislative history would be a dividend under respondent's analysis as much as under petitioner's.

This Court has described this legislative history as "not illuminating." *Commissioner v. Estate of Bedford*, 325 U.S. 283, 290 (1945). Congress clearly did not have two-party, acquisitive reorganizations in mind when it enacted the predecessor to section 356(a)(2). Consideration was not given to the effect of a transfer of boot by an unrelated corporation as partial payment for the stock of the acquired corporation. The court of appeals properly adopted the Tax Court's conclusion that all that can clearly be gleaned from the legislative history is "that the primary objective of Congress was to prevent shareholders from

bailing out earnings and profits at capital gain rates *when in essence the shareholders stood substantially in the same position before the reorganization as they did after the reorganization.*" Pet. App. 10a. (emphasis added).

F. The Decisions of This Court and of Other Courts of Appeals Do Not Compel—or Indeed Support—Petitioner's Position.

Contrary to petitioner's contention (Br. 21), the position advanced by petitioner here is not supported by *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), nor by a "long and consistent line of court of appeals decisions."

1. Bedford

In *Commissioner v. Estate of Beford*, 325 U.S. 283 (1945), this Court used language that was capable of being read to support an automatic dividend rule in all cases. *Bedford*, however, did not address the issue presented here, nor did it reach the result often ascribed to it. *Bedford* involved a classic earnings bailout which the predecessor of section 356(a)(2) was designed to circumscribe. *See* H. Rep. No. 179, 68th Cong., 1st Sess. 15 (1924). In *Bedford*, a single corporation was reorganized. The preferred shareholders simply exchanged their preferred stock for shares of a new preferred issue (with reduced rights), shares of common stock, and cash. In these circumstances, this Court held that "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' within section 112(c)(2)."

This statement by the Court in *Bedford* was viewed as a blanket endorsement of the automatic dividend rule even in factual contexts very different from the one this Court addressed. Rev. Rul. 56-220, 1956-1 C.B. 191. Because of the difficulty of reconciling this approach with the language of the statute, which implies that boot distributed in a reorganization will generally be accorded capital gain

treatment, and will be taxed at ordinary income rates only if it has the effect of a dividend, the approach came under increasing criticism by commentators. *See, e.g.*, Darrel, *The Scope of Commissioner v. Bedford's Estate*, 24 Taxes 266 (1946); Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965). The courts and the Internal Revenue Service have now retreated from the automatic dividend reading of *Bedford*. *See e.g.*, *Wright v. United States*, *supra*, at 605; *Shimberg v. United States*, *supra*, at 287; *King Enterprises, Inc. v. United States*, *supra*, at 520; Rev. Rul. 74-515, 1974-2 C.B. 118, 120. This Court has never addressed—in *Bedford* or elsewhere—the situation presented here of cash received in a reorganization involving two previously independent corporations.

2. Court of Appeals Cases

Many of the cases cited by petitioner employ, in one form or the other, an automatic dividend rule.[37] That is, they are based on the assumption—sometimes ascribed to *Bedford*—that in the context of a reorganization, any distribution of cash to shareholders of the acquired corporation is by its very nature to be treated as a distribution of that corporation's earnings and profits. In *Bedford*, this Court characterized the holdings of these earlier cases as follows:

> It has been ruled in a series of cases that where the stock of one corporation was exchanged for the stock of another and cash and then distributed, such distributions out of earnings and profits had the effect of a distribution of a taxable dividend under section 112(c)(2). *Comm'r v. Owens*, 69 F.2d 597; *Comm'r v. Forhan Realty Corp.*, 75 F.2d 268; *Rose v. Little Investment Co.*, 86 F.2d 50; *Love v. Comm'r*, 113 F.2d 236; *Campbell v. United States*, 144 F.2d 177. [325 U.S. at 291]

[37] For example, in *Commissioner v. Owens*, 69 F.2d 597, 598 (5th Cir. 1934), the test for dividend treatment articulated by the court was simply to treat as a dividend "so much of the [cash] as might before consolidating have been declared by [the acquired] corporation as an ordinary dividend out of its profits.

Petitioner's reliance on these older cases, which are consistent with the automatic dividend rule read into *Bedford*, is misplaced. In more recent years, after rejecting an automatic approach, the courts have viewed the dividend effect inquiry under section 356(a)(2) as one which requires an analysis of the effect of the boot distribution on relative stock ownership interests.

The other post-*Bedford* cases cited by petitioner (Br. 22)[38] do not display the consistent pattern he ascribes to them. In *King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969), the taxpayer sought dividend treatment because it was a corporation eligible for the dividend received deduction, and the IRS did not object. See 418 F.2d at 514, 521. In *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956), the boot consisted of cancellation of indebtedness owed by shareholders to one of the consolidating corporations, with a corresponding reduction in their stock interests relative to the other shareholders. The court in its holding noted that the indebtedness reflected earlier pro rata advances to the stockholders and that the "so-called reduction in interest was in reality a preservation of the economic status quo." 235 F.2d at 751. In *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl. 1959), the Court of Claims applied a "facts and circumstances test" to find that the payment of cash in lieu of fractional shares of the acquiring company had the effect of a dividend. Evi-

[38] Petitioner does not mention another post-*Bedford* case, in addition to *Wright*, which employs a mode of analysis similar to that of the court of appeals here, namely *McDonald v. Commissioner*, 52 T.C. 82 (1969).

dently, the taxpayer did not argue that the resulting (very small) diminution in the continuing interest he would have had if the combined company had issued fractional shares should have barred dividend treatment. He relied instead on the argument (rejected in *Shimberg*) that the transition from being a .45% shareholder of a small acquired bank to a .08% shareholder of the much larger consolidated bank was itself sufficient to bar dividend treatment.[39] In sum, none of these other cases discusses the issue presented here in any systematic way; all turn on their facts—and all reject an "automatic dividend" rule, while *King Enterprises* and *Hawkinson* apply a section 302 analysis.

3. Wright And Shimberg

Once the cases that do not address the issue are set aside, there are only two court of appeals cases—*Wright, supra*, and *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978)—which bear directly on the issue presented here.[40] Petitioner dismisses *Wright* on the ground that it involved commonly controlled corporations; and he refers to *Shimberg* as the case that "capped" the line of court appeals authority supporting his position. Br. 25-26. By contrast, the American Bar Association, the staff of the Senate Finance Committee and even the Treasury Department, as well as most of the commentators that have considered these two cases, have agreed with the court of

---

[39] In a later case applying an integrated approach to the fractional share situation, the Fifth Circuit concluded that the transaction should be viewed, in substance, as an issuance of the fractional shares by the surviving corporation followed by a payment of cash by that corporation in redemption of those shares. *See Mills et al. v. Commissioner*, 331 F.2d 321 (5th Cir. 1964). The IRS embraced this result, and the underlying rationale, in Rev. Rul. 66-365, 1966-2 C.B. 116.

[40] *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980) and a companion case, *Sellers v. United States*, 615 F.2d 1066 (5th Cir. 1980) are Fifth Circuit cases applying *Shimberg*. See note 41, *infra*.

appeals here in endorsing the result reached by the Court in *Wright* and have dismissed *Shimberg* as a sport, based in large part on misapprehension of the rationale for the opinion in *Wright*.

a. The Wright Case

In *Wright*, a note, in the amount of $102,002, was distributed to the taxpayer in connection with a merger (which qualified as a reorganization under section 368(a)(1)(A)) of two corporations in which he owned substantial interests. The purpose and effect of the distribution was to give the taxpayer a smaller interest in the surviving corporation, so that another shareholder and employee of that corporation could receive a correspondingly greater interest. In determining whether the distribution had the effect of a dividend under section 356(a)(2), the Eighth Circuit adopted the approach which was employed by the Tax Court and Fourth Circuit here. The Eighth Circuit viewed the distribution in terms of the overall transaction, held the standards of section 302 to be applicable, and, applied those standards to the distributee shareholder's interest in the surviving corporation under an all-stock transaction with no boot, and under the combined stock and boot transaction. Finding that the distributee shareholder's interest in the surviving corporation was reduced by 23.3 percentage points, the court held that there had been a "meaningful reduction" within the intendment of section 302(b)(1) and, accordingly, that the distribution did not have the effect of a dividend under section 356(a)(2).

Contrary to the petitioner's insinuation here (Br. 25-26) the decision in *Wright* was not based on the fact that the merged corporations were previously under common control. The court stated unequivocally that "we agree with the Commissioner that section 356(a)(2) should be read *in pari materia* with section 302 for the purpose of determining whether a distribution had the effect of a divi-

dend." 482 F.2d at 605. And, as pointed out above, it relied heavily on the principles underlying section 302—namely, that the "redemption provisions make sense only in relation to a corporation that will continue to exist," because those provisions focus on whether the distributee shareholder "has relinquished valuable rights in the future business," relating to "stockownership—to vote, to participate in earnings, and to share in net assets on liquidation." 482 F.2d at 607. Accordingly, the Court rejected as "artificial" viewing the case as involving redemption of the stock of any one of the individual pre-reorganization corporate parties:

> The change in ownership that would be significant due to a redemption would be a change in ownership in Omni, the corporation that would exist after the redemption and would have voting stock, earnings, and assets that would be affected. Therefore, due to the underlying rationale of section 302 and redemptions in general, we determine under the facts of this case that the taxpayer has in effect exchanged Omni stock for the $102,022 note. [482 F.2d at 608]

Thus, contrary to petitioner's attempt to attach a very narrow significance to the holding and rationale of *Wright*, the opinion of the Eighth Circuit is in fact a general rejection of his pre-merger distribution analysis, and a recognition that measuring dividend effect "make[s] sense only in relation to a corporation that will continue to exist." 482 F.2d at 607.

b. The Shimberg Case

In *Shimberg*, a closely held company (LSC) was acquired by a publicly-held company (MGIC) in a merger that qualified as a reorganization under section 368(a)(1)(A). The shareholders of LSC received stock in MGIC and $625,000

in cash. The Fifth Circuit court of appeals held that since the distribution of cash was pro rata to the shareholders of the acquired corporation, it had the effect of a dividend under section 356(a)(2).

Insofar as *Shimberg* is read as endorsing the artificially bifurcated view espoused by the petitioner, it is subject to all the objections outlined above. In particular, it analyzes the transaction in isolation from the overall context of the reorganization, on the basis of "whether the distribution would have been taxed as a dividend if made prior to the reorganization, as if the reorganization had occurred." 577 F.2d at 288. This approach, as explained above, improperly departs from the statutory standard of measuring the "effect" of the exchange as a whole.

Shimberg, moreover, appears to have rejected *Wright* on the basis of an erroneous understanding of its analysis. As both the Tax Court and Fourth Circuit noted in their opinions (Pet. App. 13a, 28a-29a) there is a serious flaw in the statement of the *Wright* holding by both the Fifth Circuit and the District Court that it reversed, and this misunderstanding may have contributed significantly to the holding of the *Shimberg* case. At the trial level in *Shimberg*, the District Court (415 F. Supp. 832 (M.D. Fla. 1976)) had relied on the decision in *Wright* to hold that the distribution to the shareholders of LSC did not have the effect of a dividend. However, the District Court misconstrued *Wright*, assuming that it required merely a comparison of the percentage interests which the acquired corporation's shareholders had owned in the *acquired* corporation prior to the merger to the percentage interests which they received in the *acquiring* corporation as a result of the merger. The District Court therefore concluded that the taxpayer's relinquishment of ownership and control of a small, local company in exchange for a "minuscule percentage of the outstanding stock of a huge, publicly-held corporation [made it] clear that the merger resulted in a radical change and meaningful reduction in the nature

of the [taxpayer's] interest in the continuing business." 415 F. Supp. at 836.

It appears that the Fifth Circuit based its reversal of the lower court's decision largely on the mistaken view that the District Court had properly interpreted and applied the approach adopted by the Court in *Wright*. As the Court below noted here, this is borne out by the Fifth Circuit's finding that

> [a] contrary holding would render section 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations. And, even in that situation, disproportionate ownership—as in Wright—could result in meaningful reduction. [577 F.2d at 288][41]

In fact, as explained above, neither the Eighth Circuit in *Wright*, nor the Fourth Circuit in this case, so held. Under

---

[41] As noted by the Tax Court (Pet. App. 28a, n.8) the Fifth Circuit's misunderstanding of the holding in *Wright* is even more clearly evidenced in *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980). In that case the two shareholders of the acquired corporation had a 2/3 and 1/3 stockownership interest, respectively, in that corporation; and after the acquisition by a publicly held company they had stockownership interests in the surviving company constituting 0.4 percent and 0.2 percent of the outstanding stock of that company. The Fifth Circuit, in discussing the holding of *Wright* stated:

> [h]ere, if the *Wright* test were applicable, we would be concerned with a reduction from a 66-2/3% and 33-1/3% interest in Oliver stock for [the two shareholders] respectively to a 0.4% and 0.2% respective interest in the outstanding USI stock. [615 F.2d at 1066]

In *General Housewares*, as well, the Fifth Circuit thus misinterpreted the holding of *Wright* as requiring a comparison of shareholder interests in the acquired corporation to those in the surviving corporation.

the opinion in *Wright*, as under that of the court of appeals here, the stock interest which the shareholders of the acquired corporation receive in the acquiring corporation as a result of taking cash boot is compared to the stock interest *in that same corporation*, the acquiring corporation, which they would have received under an all-stock transaction.

In sum, the position taken by the court below—and in *Wright*—is fully consistent with the statute, reflects economic reality, and provides a workable and certain standard.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

*WALTER B. SLOCOMBE
DANIEL B. ROSENBAUM
CAPLIN & DRYSDALE, Chartered
One Thomas Circle, N.W.
Washington, D.C. 20005
(202) 862-5000

June 1988

*Counsel of Record

(7)

No. 87-1168

Supreme Court, U.S.
FILED
JUL 20 1988
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

	Page
Cases:	
Commissioner v. *Owens*, 69 F.2d 597 (5th Cir. 1934)	7
Helvering v. *Minnesota Tea Co.*, 296 U.S. 378 (1935)	7, 8
Minnesota Tea Co. v. *Commissioner*, 28 B.T.A. 591 (1933)	8
Minnesota Tea Co. v. *Helvering*, 302 U.S. 609 (1938)	8, 9
Ross v. *United States*, 173 F. Supp. 793 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959)	7
Shimberg v. *United States*, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979)	11, 12
Statutes:	
Internal Revenue Code of 1954 (26 U.S.C.):	
§ 302	4, 9, 10
§ 312(a)(2)	7
§ 316	2, 8
§ 318	9, 10
§ 356	9
§ 356(a)(2)	*passim*
§ 368(a)(1)(C)	9
§ 368(a)(1)(D)	10
Miscellaneous:	
H.R. 8300, 83d Cong., 2d Sess. (1954)	12
H.R. Rep. 179, 68th Cong., 1st Sess. (1924)	10
H.R. Rep. 1337, 83d Cong., 2d Sess. (1954)	12
Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 Tax L. Rev. 297 (1984)	4
Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance, 98th Cong., 1st Sess. (1983)	11
Rev. Rul. 76-385, 1976-2 C.B. 92	6
Revised Report on Corporate Distributions and Adjustments to Accompany Subchapter C Advisory Group Proposed Amendments, as Revised	12
S. Rep. 1622, 83d Cong., 2d Sess. (1954)	6

In the Supreme Court of the United States

OCTOBER TERM, 1988

No. 87-1168

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

1. In our opening brief, we argued that the distribution of cash to respondent, in the course of a merger of his wholly-owned corporation (Basin) into a subsidiary of a larger corporation (NL), had "the effect of the distribution of a dividend" within the meaning of Section 356(a)(2) of the Code. We explained that the distribution of boot on a pro rata basis to the shareholders of the acquired corporation (in this case, to the sole shareholder of Basin) has all the earmarks of a classic dividend, to the extent of the corporation's accumulated earnings and profits (see Gov't Br. 15-27). We also explained that the court of appeals' holding that "the boot should be characterized as a post-reorganization stock redemption by N.L. [of stock hypothetically received in a pure stock-for-stock reorganization]" (Pet. App. 7a), which gives respondent the tax treatment of the transaction that he specifically declined to consummate, cannot be reconciled with the terms of the statute and is mistaken on several counts (Gov't Br. 27-39).

Respondents' general response to our argument is the assertion that only the result reached by the court of appeals is faithful to the "reality of the situation" (Resp. Br. 4). The objection to our argument is couched in various phrases. Respondents claim that the courts below decided the case in the "realistic" (Br. 9, 17, 25 n.24) context of the "overall" (Br. 8, 13, 15, 16) or "integrated" (Br. 6, 7, 8, 9, 16) transaction; the government, on the other hand, "bifurcate[s]" (Br. 7, 16) the transaction "artificial[ly]" (Br. 16, 17, 24, 25) by viewing the distribution of the cash "in isolation" (Br. 4, 8, 13, 25). Respondents' argument appears to be summarized in the following passage (Br. 9-10 (emphasis in original)): the case can be decided "only by considering the effect of the exchange in the context of the transaction *as a whole,* as the courts below did, not as if the cash had been received in isolation, as the petitioner would have this Court do." Respondents' argument completely misses the mark. The government's analysis fully comports with the text of the statute. It is respondents' analysis, which pretends that the boot was distributed in a hypothetical post-reorganization redemption of shares that were never owned by respondent, that "artificially bifurcates" the overall transaction.

It is undisputed that the boot distribution here took place in the course of the reorganization—not before or after it. Thus, it was not a direct distribution of property from a corporation to its stockholders as could occur outside a reorganization—*i.e.,* it was not a "dividend" as defined in Section 316 of the Code.[1] But Section 356(a)(2)

[1] The entire merger transaction took place on one day, April 18, 1979, and its elements were for all practical purposes simultaneous. Accordingly, the "step transaction doctrine," which respondents rely upon and criticize the government for not mentioning (see Resp. Br. 14-16 & n.10), is inapplicable here. That doctrine examines a series of apparently separate transactions to determine whether they should be treated as a unified transaction.

asks whether this distribution had "the effect of the distribution of a dividend," and thus it explicitly channels the inquiry towards a comparison with the effect of a direct distribution of cash to the shareholders of a single corporation. Therefore, to the extent the government's comparison of the boot distribution with a dividend (*i.e.,* with a pro rata payment outside the context of a reorganization) views "the cash * * * in isolation" (Resp. Br. 4), that is what the statute demands.[2] And, if the transaction has "the effect of the distribution of a dividend," it is irrelevant under the statute whether, seen from another angle, it can be said to resemble some other transaction, such as a redemption that is not essentially equivalent to a dividend (see Gov't Br. 37). The approach of the courts below, by contrast, lacks a statutory basis; it "artificially bifurcates" (see Resp. Br. 16) the merger transaction into a reorganization and a "post-reorganization stock redemption" (Pet. App. 7a).[3]

[2] Moreover, because the statute establishes that the amount of any dividend is to be measured by the earnings and profits of the acquired corporation (see Gov't Br. 34-35), it channels the inquiry towards a comparison with a distribution by that corporation, whose shareholders are the ones in a position to take advantage of a possible bail-out of earnings and profits in the course of the reorganization.

[3] Although respondents studiously avoid referring to their approach as hypothesizing a post-reorganization redemption, it is apparent that their analysis is no different from that of the court of appeals. Respondents explain that there was no dividend here because the consequence of the exchange was that respondent "had a significantly smaller ownership interest in the continuing enterprise—by some 30 percent—than he would otherwise have had if the exchange had involved entirely NL stock" (Br. 13 (footnote omitted)). They further state that respondent's interest in the surviving corporation "was diminished by reason of having received" the boot (Br. 25) and that the effect of the distribution was respondent's " 'relinquishment of a portion of his interest in the newly reorganized

A simple examination of the change in respondent's ownership interest "in the context of the transaction *as a whole*" (Resp. Br. 9-10 (emphasis in original)), which is the yardstick that respondents purport to be using, clearly shows that respondents in fact are not looking at the overall transaction; moreover, it demonstrates the complete unsuitability of making Section 356(a)(2) determinations by means of a blind application of Section 302 principles to a hypothetical redemption. The "minnow-whale" reorganization that occurred here, regardless of its precise details, was intended to transform respondent from the sole shareholder of Basin to the holder of a small percentage of shares in the continuing enterprise. If respondent had accepted the pure stock-for-stock option, his interest in the continuing enterprise would have gone from 100% in Basin to 1.3% in NL. It is undisputed that this enormous reduction in respondent's interest and loss of control would have been viewed as an ordinary incident of the reorganization and not considered in determining whether dividend treatment is appropriate (see Pet. App. 13a; Br. in Opp. 15 n.18; Resp. Br. 41-42; see generally Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2),* 39 Tax L. Rev. 297, 325-326 (1984)). The position of the courts below, however, is that the

corporation' " (Br. 14 (quoting Pet. App. 2a)). Of course, there was no actual diminution or relinquishment of any interest of respondent's in NL either in the course of the reorganization or afterwards. He had never previously held any more than the 300,000 shares of NL stock that he held after the reorganization was completed. One can speak of a diminution or relinquishment of respondent's interest in NL—and apply to that diminution the standards of Section 302 (see Resp. Br. 13 n.8, 18-23)—only if one hypothesizes that respondent received 425,000 shares of NL in a stock-for-stock reorganization and then subsequently redeemed 125,000 of those shares in exchange for the amount of the boot.

slightly greater reduction of interest that actually occurred here as a result of the reorganization involving boot, from 100% ownership to 0.92%, is inconsistent with dividend treatment because it is a "meaningful reduction" in interest (Resp. Br. 9). Plainly, this result derives not from examination of the "overall transaction," but rather from viewing receipt of "the cash * * * in isolation" in a hypothetical post-merger redemption.

Congress clearly was aware when it enacted Section 356(a)(2) that a reorganization likely will involve a reshuffling of shareholder interests and the loss of some degree of corporate control. It was also aware that, when boot is distributed in the reorganization, the shareholders of the acquired corporation inevitably will be left with a smaller interest in the continuing enterprise than they would if the reorganization were purely stock-for-stock. Congress did not view that fact as inconsistent with dividend treatment of boot, however, and it established as the test an inquiry into whether the boot distributed in the course of the reorganization has the same effect as the distribution of a dividend that would occur outside the reorganization. This test is perfectly sensible and does not fail to account for the difference in post-reorganization corporate control between the two options. After all, if the acquired corporation directly distributed a dividend to its shareholders as part of the overall transaction, the shareholders obviously would obtain a smaller interest in the continuing enterprise than if the dividend had not been distributed; that fact, however, would not prevent the payment from being taxed as a dividend. See pages 7-9, *infra*.[4]

[4] That respondents' approach depends upon "artificially bifurcating" the transaction is also illustrated by the fact that respondents would apply to the hypothetical reduction in corporate interest computed under their theory Revenue Rulings holding that "even a quite small reduction in the interest of a minority shareholder" may pre-

2. At some points in their brief, respondents appear to suggest that the transaction should be viewed as a *sale* of part of respondent's interest in Basin for cash and a stock-for-stock exchange for the remainder. See Resp. Br. 9, 19, 28-29. As we noted in our opening brief (at 19 n.11), however, treating the transaction as a sale is flatly inconsistent with the fact that it was a reorganization under the Code; reorganization treatment, on the theory that the transaction was merely a reshuffling of interests in a continuing enterprise, conferred substantial tax benefits upon respondent. If the transaction that occurred here had been a *sale,* the more than $10 million of gain realized by respondent on the merger (see Gov't Br. 4 n.4) would all have been taxable; instead, under the reorganization provisions, respondent was not required to recognize and pay tax on the gain except to the extent of the $3,250,000 in cash that he received. Respondents cannot have it both ways. Under the continuing enterprise premise that justifies nonrecognition treatment, the boot payment must be regarded not as a purchase, but as a distribution by a corporation to its shareholders that can have the effect of a dividend.

3. Respondents object (Br. 17, 26, 28) that the boot payment cannot be characterized as a dividend in the

clude dividend treatment (see Resp. Br. 33 n.36). Those rulings are premised in large part, however, on the practicalities of being a minority shareholder; he "exercises no control over [corporate] affairs" and hence lacks the power to use a redemption to disguise a dividend. Rev. Rul. 76-385, 1976-2 C.B. 92, 93; see also S. Rep. 1622, 83d Cong., 2d Sess. 44 (1954). That rationale can apply here only if one focuses exclusively on the hypothetical post-reorganization redemption; if one looks at the "overall" transaction, respondent exercised complete control over the affairs of his corporation and surely had the power to issue a dividend or otherwise control the form in which Basin's earnings were distributed to him.

amount of Basin's accumulated earnings and profits because Basin's financial condition before the reorganization was not sufficiently liquid to have allowed it to make a cash distribution in that amount.[5] That objection is unsound for two reasons. First, the liquidity problem would not necessarily have prevented Basin from declaring a dividend. It could have distributed a dividend in the form of its own obligation (see, *e.g.*, I.R.C. § 312(a)(2)) or it could have borrowed funds to distribute a dividend. More fundamentally, however, respondents' objection is irrelevant because Section 356(a)(2) does not ask whether the boot distribution was in actuality a dividend issued by the acquired corporation; rather, it asks whether the boot had "the effect of the distribution of a dividend." Accordingly, as we noted in our opening brief (at 23), it was repeatedly recognized in the established line of authority treating pro rata boot distributions as dividends that it is immaterial to that determination whether the acquired or the acquiring corporation actually pays out the cash to the shareholders. See, *e.g.*, *Commissioner* v. *Owens,* 69 F.2d 597, 598 (5th Cir. 1934); *Ross* v. *United States,* 173 F. Supp. 793, 798 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959).

The facts of one of the landmark reorganization cases decided by this Court, *Helvering* v. *Minnesota Tea Co.,* 296 U.S. 378 (1935), which closely parallel those in this case, well illustrate that the boot distribution in this case had the "effect of the distribution of a dividend." That case involved a corporate transaction in which Minnesota

[5] Although respondents state that the amount of the boot distribution exceeded not only Basin's cash, but also its net assets (see Br. 17, 26, 28), it has never been contended that the entire amount of the boot distribution should be treated as a dividend. Rather, dividend treatment is limited to an amount equal to Basin's accumulated earnings and profits, which concededly did not exceed its net assets (see Resp. Br. 26).

Tea transferred all of its assets to the Grand Union Company in exchange for 18,000 shares of Grand Union stock and $426,842 in cash. The cash was immediately distributed by Minnesota Tea on a pro rata basis to its three stockholders. 296 U.S. at 381-382. This transaction gave rise to considerable litigation over whether it was a reorganization (see 296 U.S. 378 (1935) (holding that it was)) and over the extent of Minnesota Tea's allowable deductions (see 302 U.S. 609 (1938)). It was agreed by all, however, that the cash payment was taxable as a dividend to the shareholders to the extent of their ratable share of Minnesota Tea's earnings and profits, and they so reported the cash payment on their tax returns. The conclusion that these payments were dividends, of course, followed directly from the predecessor of Section 316 of the Code since the cash was a pro rata distribution paid by Minnesota Tea to its shareholders.

The facts of *Minnesota Tea* are almost exactly parallel to those of this case. In both cases, the boot for the reorganization was paid by the acquiring corporation and, applying the approach of the court below, the shareholders' interest in the continuing enterprise was significantly reduced as compared to what it would have been had there been a pure stock-for-assets reorganization, without boot.[6] The only difference is in the form of

[6] If the boot received by the shareholders of Minnesota Tea is converted to stock at its approximate market value of $30/share (see 28 B.T.A. 591, 592 (1933)), the actual reorganization with boot yielded a 44% reduction from the interest that the shareholders would have held in Grand Union under a hypothetical pure stock-for-assets reorganization, without boot. In this case, the analogous diminution of interest was 30% (see Resp. Br. 13). Moreover, as in this case, Minnesota Tea lacked the liquidity to pay a dividend out of its own funds; in fact, part of the transaction was that the shareholders would use the cash they received in the reorganization to satisfy more than $100,000 of the corporation's debts (296 U.S. at 381).

the reorganization. This case involves a statutory merger in which the acquired corporation ceases to exist as an independent entity; *Minnesota Tea* involved a transfer of assets, which would now be classed as a "C" reorganizaton (I.R.C. § 368(a)(1)(C)), in which the "acquired" corporation retains its existence as a "shell." Because of that difference, respondent's ownership interest after the reorganization was reflected in direct ownership of NL stock; in *Minnesota Tea,* the shareholders' interest was reflected in ownership of shares in a "shell" corporation, which owned nothing but shares in Grand Union, the continuing enterprise. This difference in the form of ownership is irrelevant, however, with respect to a comparison of interests in the continuing enterprise or any other policy relevant to Section 356(a)(2). Accordingly, if the boot distribution in *Minnesota Tea* was a dividend—and there is no basis for disputing that it was—the closely analogous boot distribution in this case must have had "the effect of the distribution of a dividend."

4. Respondents assert (Br. 20 n.18) that Congress's action in 1984 in amending Section 356(a)(2) to apply to it the attribution rules of Section 318 of the Code demonstrates the correctness of their argument that Section 302 redemption principles must be used to determine dividend equivalency under Section 356. "Unless the section 302 test of a change in ownership interest were to be applied for section 356(a)(2) purposes," respondents argue (Br. 21 n.18), "there would be no need for an attribution rule to compute such ownership interests." This argument is clearly mistaken; the attribution rules are as relevant under the government's approach as they are under respondents' approach. Suppose, for example, that A owned 30% of the stock of a corporation acquired in a merger and B owned the other 70%. If A received only cash on the merger and B received shares of the acquiring

corporation, it would seem clear that the payment to A would not have the effect of a dividend under Section 356(a)(2) since it not only was not pro rata, but also completely terminated A's interest in the continuing enterprise. But if it develops that A and B are father and son, which means that their respective stock ownership interests must be attributed to each other under Section 318, then the boot distribution becomes pro rata to a sole shareholder and should be treated as a dividend. Thus, the relevance of the attribution rules of Section 318 does not turn on any reference to Section 302.

5. As we noted in our opening brief (at 20), the legislative history of the predecessor of Section 356(a)(2) suggests that Congress wanted to provide dividend treatment when the effect of the receipt of the boot is "the same as if the corporation had declared out as a dividend its * * * earnings and profits" (H.R. Rep. 179, 68th Cong., 1st Sess. 15 (1924)), as is the case here. Respondents maintain, however, that this legislative history counsels rejection of the government's position because the example given by Congress shows that it was concerned about abuse where "a *single* corporation reincorporated in a transaction which qualified as a reorganization" (Resp. Br. 33 (emphasis in original)). Clearly, Congress did not intend to restrict the application of Section 356(a)(2) to such cases. The situation described in the committee reports was put forth as an example and was not intended to be exclusive. If Congress had sought to limit the application of Section 356(a)(2) in the manner suggested by respondents, it could easily have accomplished that goal in the statute itself by limiting its application to "D" reorganizations (I.R.C. § 368(a)(1)(D)). It did not do so, and therefore Section 356(a)(2), together with its underlying purposes as reflected in its legislative history, is fully applicable to reorganizations such as the one in this case that do not involve only a single corporation.

6. Respondents state that "leading scholars and commentators" (Br. 23), as well as the Treasury Department, agree with the result below and "have dismissed [the contrary decision in] *Shimberg* [v. *United States*, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979),] as a sport" (Resp. Br. 39). As we stated in our reply at the petition stage (at 3, 6-8), this extravagant assertion is without foundation. First, the "leading scholars and commentators" cited by respondents (Br. 23 n.22) primarily are private attorneys writing in practitioners' journals; it is hardly surprising that they take a position supporting capital gain treatment, which is generally favorable for their clients. Several scholars approaching the issue from a more disinterested perspective, however, have recognized that boot distributions made on a pro rata basis to the shareholders of the acquired corporation should be treated as dividends under Section 356(a)(2) (see, *e.g.*, Gov't Br. 19, 21, 25 n.13).

With respect to respondents' suggestion that Congress and the Treasury Department have embraced the result below, we explained in detail in our reply at the petition stage (at 6-8) that respondents have misinterpreted the significance of the Treasury Department's comments on the recent proposals to revise Subchapter C of the Internal Revenue Code, which were never enacted. Though it viewed the question as a "close call," the Treasury Department stated that, "[o]n balance," it did not oppose a provision that would have codified the result below, "in the context of the overall project," which contained other changes that would have relaxed existing limitations on the amount of boot dividends. See *Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 24-25 (1983); Gov't Reply Br. 6 & n.5. This comment did not declare the result below to be good policy, and it certainly did not acknowledge it as a correct

construction of existing law. On the contrary, to the extent that the Treasury Department's comments addressed the meaning of the existing version of Section 356(a)(2), they indicated a preference for the *Shimberg* case that is contrary to the decision below.

Nor can it reasonably be said that Congress has "dismissed *Shimberg* as a sport" (Resp. Br. 38-39) simply because the most recent Senate proposal to restructure Subchapter C would have codified the result below—among many other changes. As the Tax Court noted (Pet. App. 30a n.9), there have been numerous proposals at various times to amend the Code to address "boot dividends" more explicitly, some of which would have specifically rejected the result below. For example, the House version of the 1954 Code applied numerical disproportionate distribution criteria to boot distributions, but it also expressly provided that the criteria would apply with reference to the "shareholders of the corporation in which the shareholder held stock immediately prior to the transaction" (see H.R. 8300, 83d Cong., 2d Sess. § 306 (1954)). Therefore, pro rata payments to the shareholders of the acquired corporation would have "the effect of the distribution of a dividend" to those shareholders, to the extent of the corporation's earnings and profits. See H.R. Rep. 1337, 83d Cong., 2d Sess. A85-A86 (1954). A distinguished advisory group appointed by the House to study Subchapter C made a similar recommendation in 1958, noting that the test of disproportionateness should be applied to the shareholders of the acquired corporation, "not by reference to the percentage holdings in the transferee corporation as a whole." See *Revised Report on Corporate Distributions and Adjustments to Accompany Subchapter C Advisory Group Proposed Amendments, as Revised* 68-69 (GPO Dec. 11, 1958). What is significant is that

Congress has never enacted any of these proposed major revisions of the statutory framework. Instead it has left the characterization of boot distributions to be governed by the longstanding rule of Section 356(a)(2), which the great weight of authority has construed for 50 years to require dividend treatment for boot distributions made on a pro rata basis to the shareholders of the acquired corporation (see Gov't Br. 21-27).

For the foregoing reasons, and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

CHARLES FRIED
Solicitor General

JULY 1988

U.S. GOVERNMENT PRINTING OFFICE: 1988—202-037/60564